

ALAN PINK TAX

Tearing the Business in Two

A lot of the readers of these articles who are in business will have bitter memories of what it is to be in partnership. Business partnership must be one of the toughest relationships there are to maintain. And to make matters worse, when you finally decide to split, the silent partner in your business, that is the taxman, tends to make things even harder.

So this article is devoted to finding an antidote to these problems.

Splitting the Property Portfolio

One way in which people tend to get apparently inextricably linked with each other financially, and subsequently regret doing so, is acquiring jointly held property portfolios. It all seems like a good idea when you are getting on well together, but when you start moving in different directions, and wanting to do different things with the value of the property portfolio, the problems start.

Let's have a look at an all too common scenario.

David and Jonathan own a property portfolio worth £5 million together. They've acquired this over a number of years, and the actual cost of the portfolio was less than half that. David decides that now is the time actively to exploit the portfolio by developing it, but Jonathan just isn't interested. Neither can do a thing without the other's consent, and so we reach a teeth-gnashing stalemate. After one particularly bitter row, they decide that the only thing to do is go their separate ways, sell the portfolio, and move on.

Then their accountant tells them what the tax cost of doing so is likely to be: 18% of the resultant capital gain will set them back something like £0.5 million in tax, leaving them both with much less to reinvest going forward. So is there a solution?

Long standing readers of these words will know that I'm not into just telling people they've got problems. I am more interested in solutions. And there is a very neat solution to this problem which just needs a bit of tax

knowledge. This is to do a formal splitting of the joint interests so that each of David and Jonathan has as near to half of the total value as is possible. If their portfolio consists of ten properties, say, David could end up with properties one to five in his 100% ownership, and Jonathan with properties six to ten. The only tax we are left with is Stamp Duty Land Tax, which will apply at 4% on the above numbers.

Trading Partnerships

A similar problem, and potential solution, arises where two or more people are in partnership together and decide to go their separate ways. The tax rules, on the face of them hostile and obstructive to such a move, can be got round in a way that avoids most or all of the potential tax liability.

But now we come to the really tough one.

If your trading “partnership” isn’t actually a partnership at all, structurally, but is run through the medium of a limited company, you have got two, or possibly three, tough tax nuts to crack before you can walk away from the business.

If everything is in a company, the natural way to split in two, if it weren’t for tax, would be to wind-up the company and form two new ones, where the old shareholders each own 100%. Each new company then takes over the relevant part of the old company’s trade.

This is definitely within the category of “don’t try this one at home”! Unless you do this exactly right, you’re going to end up with two crippling tax charges, unless you’re very lucky.

The first tax charge is a capital gains liability on the wind-up of the old company. There is no form of “rollover relief”, even though effectively you’re reinvesting everything into a new company.

The second tax charge is on the old company itself. What many people tend to forget is that, when you wind-up an actively trading company, it’s treated as disposing of all of its assets at their market value. If the company was profitable, one of the assets concerned is going to be the goodwill of the business, which again tends to be overlooked because it’s rarely shown on the balance sheet. Nevertheless, the deemed sale of this goodwill for its market value could be very expensive in terms of corporation tax on chargeable “gains”.

Isn't our tax system helpful? All shareholders A and B are trying to do in this example is remove barriers to the success of the constituent trades in the company. They haven't made any gains: it's all still just written down on paper. But the taxman pursues them for a huge slug of money. Is planning to avoid this arbitrary and unfair tax charge "unacceptable tax avoidance"?

The Answer

The answer, very often, is to do a special sort of winding-up for the old company known as an "Insolvency Act reconstruction". As this is a family article, we won't go into all the gory technical detail of how this works, but at the end of the day it gets you out of both of those tax charges by making use of special reliefs. But you do have to do it the right way.

There is another way of demerging companies using the so called "demerger relief" provisions, but without wanting to seem dismissive, we've never actually seen demerger relief come in useful in any practical situations.

Quasi Demergers

Insolvency Act reconstructions can work very well, and work best where you've got an uncomplicated situation and the assets are being split roughly down the middle. Sometimes, though, this isn't the case.

So we've seen, in practice, the "quasi demerger" arrangement used. This works something along the following lines.

Instead of knocking the old company on the head, we change its share capital so that it has "A" and "B" shares, which you get simply by renaming the existing shares. No shares are disposed of or acquired, and so there is no capital gains tax issue at this stage. The next stage is to perform some surgery on the company's constitution, by altering its memorandum and articles of association. To take an example to illustrate the point, let's say a company has two retail shops that Mr A and Mr B, who own the company 50/50, run separately. The memo and arts are changed so that shop number one and its business is attributable entirely to the A shares and shop number two to the B shares. All profits from the separate shops give rise to dividends, or the right to assets on ultimate winding-up of the

company, for the separate shares. So the company hasn't disposed of anything either, and again you don't have this problem with capital gains.

Although that's a simplified example, which you could probably actually sort out by way of an Insolvency Act reconstruction, we have seen cases where the business has been carried on partly by companies and partly in partnerships, and things get really complex when you want to split the totality of such businesses in two.

What you can also do, having done a quasi demerger, is introduce one or both of the new separate halves of the business into separate partnerships with different partners. This emphasises the separate nature of the two parts of the business even more. But to talk about the possibilities of a business carried on in partnership between a company and individuals is a whole new subject....

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