Practice guide

Lifecycle of a business: succession planning

Speed read

Owners of trading businesses potentially enjoy significant capital tax breaks. Business property relief is a generous relief from IHT, but investment activity, business assets not used for business purposes and debt arrangements can jeopardise the relief. Gift relief from CGT may be available but needs to be claimed and is subject to claw-back. Although the current tax rules are very favourable, they may change in future, so lifetime giving should still be considered.

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In the rush to build a profitable business, succession planning is regularly overlooked at the outset of a new venture: it is often only considered at the time of an exit, if at all. However, even for young entrepreneurs, succession planning should be considered at an early stage. Succession planning is not necessarily synonymous with planning for an individual shareholder's death; in the widest sense it could include transferring shares to family members or new investors in the business while the founders are very much alive.

In this second of a series considering the lifecycle of a business, this practice guide considers the succession planning issues that entrepreneurs should consider at both an early stage and throughout the lifecycle of their business.

IHT considerations

BPR offers a generous relief from IHT for transfers of 'relevant business property', whether made in lifetime or on death (IHTA 1984 s 104). BPR operates by reducing the value placed on 'relevant business property' for IHT purposes in the event of a transfer. Even if founding shareholders are not contemplating their own mortality just yet, doing what they can, within the constraints of their business, to ensure that their shares qualify as relevant business property, makes good sense. It is also worth remembering that participators in a close company can find that there are IHT implications for themselves personally if the company makes transfers of value (IHTA 1984 ss 94–97). The value transferred by the company is apportioned among its participators.

'Relevant business property' includes:

(a) property consisting of a business or interest in a business;
(b) securities of a company which are unquoted and which (either by themselves or together with other such securities owned by the transferor and any unquoted shares so owned) gave the transferor control of the company immediately before the transfer;
(c) any unquoted shares in a company;
(d) shares in or securities of a company which are quoted and which (either by themselves or together with other such shares or securities owned by the transferor) gave the transferor control of the company immediately before the transfer;
(e) any land or building, machinery or plant which, immediately before the transfer, was used wholly or mainly for the purposes of a business carried on by a company of which the transferor then had control or by a partnership of which he then was a partner; and
(f) any land or building, machinery or plant which, immediately before the transfer, was used wholly or mainly for the purposes of a business carried on by the transferor and was settled property in which he was then beneficially entitled to an interest in possession.

'Unquoted' shares and securities means any shares or securities not listed on a recognised stock exchange, including AIM listed shares. 'Control' is defined in IHTA 1984 s 269 and broadly means control through voting power.

BPR is available at a rate of 100% for assets within categories (a) to c) and at 50% for assets within categories (d) to (f). However, there are limits to the generosity of BPR and some of the key pitfalls and planning opportunities are discussed below.

Investment activity

IHTA 1984 s 105(3) provides that an interest in a business, or shares or securities of a company, are not relevant business property if the business, or the business carried on by the company, consists wholly or mainly of dealing in securities, stocks or shares, land or buildings and/or making or holding investments. It is not fatal to BPR if there is an element of investment activity in the business, but it must not be allowed to dominate. To determine if the business is wholly or mainly an investment business, the business should be looked at in the round. In *Farmer v IRC* [1999] STC 321, an analysis was made of the business as a whole to determine whether the business consisted mainly of holding investments, including how business capital was deployed, turnover and profits, and what the business owners and staff spent their time doing.

As a company develops its operations, it is wise to build in regular reviews to check that the company is not diversifying its activities to such an extent that it is in danger of meeting the 'wholly or mainly' test, at which point the relief would be lost entirely. If need be, the company could reorganise its activities into a trading subsidiary and an investment subsidiary. BPR would not be available for the investment subsidiary but would be preserved at least for the trading subsidiary. If the re-organisation involves creating a holding company for the two subsidiaries, relief is available for the holding company but not on the value attributed to any investment subsidiaries.

'Excepted assets'

The value of any relevant business property which is attributable to an 'excepted asset' will be denied relief.

Case study 1: Settling HG Ltd shares into trust – IHT considerations

Helen and Gemma decided to go into business together and established HG Ltd, a UK incorporated and tax resident trading company. The issued share capital of HG Ltd is owned 60% by Helen and 40% by Gemma.

In February 2021, as part of her personal succession planning, Helen decides to settle half of her HG Ltd shares into a discretionary trust.

Prior to making the settlement, Helen should check whether she is able to freely gift her shares in HG Ltd under the company's article of association and the terms of any shareholder agreements between Helen and Gemma.

Assuming Helen can gift the shares, as HG Ltd is an unlisted trading company with no investment activity, Helen's shares should qualify as relevant business property. If Helen has held her shares for more than two years, BPR will be available at a rate of 100% and no IHT entry charge should apply to the settlement of the shares into trust.

Transfers into virtually all trusts are chargeable lifetime transfers for IHT. Transfers of shares during any early, loss making years may not qualify for BPR as businesses not carried on for gain do not qualify for relief (IHTA 1984 s 103(3)). Gifts of BPR qualifying assets into settlor interested trusts can give rise to reservation of benefit issues if the shares do not remain BPR qualifying. The trustees should consider BPR availability well ahead of any IHT charge events such as ten-year anniversaries or capital exits. If the trustees sell the shares and do not replace them with other BPR qualifying assets, or otherwise cease to own them beneficially, and Helen dies within seven years of the gift into trust, the trustees may have an IHT bill (IHTA 1984 s 113A).

A potential CGT charge for Helen should also be considered (see case study 2, overleaf).

IHTA 1984 s 112(2) provides that an excepted asset is one which is:

- not used wholly or mainly for the purposes of the business concerned throughout the last two years before the IHT event in question (or since acquisition, if that occurred more recently); and
- not required at the time of the IHT event for the future use of the business.

In situations where large cash balances start to build up on the company's accounts, board minutes should regularly record how and when sums will be used for business purposes and should give a plausible business case for why the cash is being held.

Secured debts

BPR is only available in respect of the net value of the BPR qualifying asset (IHTA 1984 s 110) and therefore debts secured against relievable assets is a waste of a good IHT relief. If guarantees need to be given for business loans, for BPR purposes it is preferable that they are secured against other personal assets. If debts are incurred for the purposes of financing BPR qualifying assets, the debt is primarily deductible against the BPR property, regardless of what it is secured on (IHTA 1984 s 162B). For example, a mortgage secured on a home is not deductible for IHT purposes against the value of the home if the funds released are used to finance a BPR qualifying business. The interplay between s 162B and s 175A demands careful reading.

Minimum ownership requirement

Any relevant business property must be owned for a minimum period of two years before it can qualify for BPR (IHTA 1984 s 106), although there is no requirement that the property must have qualified as relevant business property throughout the two-year period. For many start-up businesses, shares are unlikely to have much value for the first couple of years trading. If shares (or other relevant business property) may have a significant value in the first two years of ownership, term life cover written in trust could be used to protect against IHT exposure during the initial two-year period.

Giving BPR qualifying assets to a trust

While trusts remain a classic vehicle for holding family wealth long term, an IHT entry charge applies at a rate of 20% on the transfer of any relevant property to a trust in excess of the settlor's available nil rate band (currently £325,000). If relevant business property is transferred to a trust and the conditions for BPR are satisfied, the usual IHT entry charge is avoided. (See case study 1.)

Will planning

As the availability of BPR is dependent on a number of variables, making a will to provide for the shares to pass to a spouse or civil partner if the value of the shares do not qualify for 100% BPR at death, allows the equally generous 100% IHT spouse exemption to act as a safety net (note the spouse exemption may be restricted in cases of domicile mismatch). A well worded will can cater for differing dispositions depending upon whether the full value of the shares qualifies for BPR at death or not.

There may also be merit in making provision for BPR qualifying assets to pass into a will trust for the shareholders' family, rather than to their spouse. This ensures that if the shares are sold by the will trustees following death, and the cash proceeds are not reinvested in BPR qualifying assets, the proceeds will only suffer periodic IHT charges as unrelieved relevant property in the trustees' hands. Contrast the position with the 40% IHT rate that the proceeds might suffer if owned by the surviving spouse at death.

Making a lifetime gift of BPR assets

Why make lifetime gifts of 100% BPR qualifying assets? When BPR relief was first introduced in 1976, the maximum relief rate was 30%. In its recent, second inheritance tax review (July 2019), the Office of Tax Simplification recommended that the government consider whether it continues to be appropriate for the level of trading activity for BPR to be set at a lower level than that for CGT gift hold-over relief or entrepreneur's relief. In short, there is no guarantee that the current favourable BPR regime will continue to apply.

CGT considerations

If a shareholder gives away shares during their lifetime, he/she will be making a chargeable disposal of those shares. Any gain arising on the disposal will be subject to CGT at the shareholder's marginal rates (subject to any available annual exemption). However, if a gift of shares is made to another individual, company or trustees of a settlement (the transferee), hold-over relief can defer the tax due on any chargeable gain arising on the disposal.

Section 165 holdover relief

TCGA 1992 s 165 provides for hold-over relief on the disposal of business assets by an individual or trustee where the disposal is not at arm's length (for example, a disposal by way of gift).

Where available, any gain arising on the disposal can be 'held over' until a subsequent disposal by the transferee. This is achieved by:

1. reducing the amount of any gain accruing to the transferor on the disposal by the amount of the held over gain; and
2. reducing the amount of consideration for which the transferee is deemed to have acquired the asset for by the amount of the held over gain.

The relief is available in relation to:

- an asset, or an interest in an asset, used for the purposes of trade, profession or vocation carried on by the transferor or his/her 'personal company' or a member of a trading group of which the holding company is his/her 'personal company'; or
- shares or securities of a trading company (or the holding company of a trading group) that are not listed on a recognised stock exchange, or where the relevant company is the transferor's personal company.

For these purposes, a personal company is defined as a company in which an individual can exercise not less than 5% of the voting rights. Voting rights do not actually need to be exercised, but they must be capable of being exercised (*Hepworth (Insp of Taxes) v Smith* (1981) 54 TC 369). The terms 'holding company', 'trading company' and 'trading group' are defined in s 165(8). HMRC's *Capital Gains Manual* at CG50250–CG50260 sets out HMRC's current view of what is accepted as a 'recognised stock exchange'.

In assessing whether a claim for hold-over relief can be made under section 165, advisors should consider the concept of 'trade' and 'trading companies' as this will materially affect the availability of the relief. In this context 'trade' has been accepted as meaning a trade, profession or vocation which is conducted on a commercial basis with a view to realising profits.

A 'trading company' is one carrying on trading activities whose non-trading activities are not a substantial part of the whole. HMRC generally takes the view that 'substantial' means more than 20% (CG64090). 'Trading activities' are widely defined as activities carried on by the company:

- in the course of, or for the purposes of, a trade being carried on by it;
- for the purpose of preparing to carry on a trade;
- with a view to acquiring or starting to carry on a trade; or
- with a view to acquiring a 'significant interest' in the share capital of another company that is itself a trading company or the holding company of a trading group and that is not already a member of the same group as the acquiring company.

Section 165 relief is not automatic and must be claimed by both the transferor and transferee (unless the transferee is the trustee of a settlement). Such claims cannot be made in an individual's self-assessment return and, instead, a form HS295 must be completed and submitted. Claims must be made within four years of the end of the year of assessment in which the disposal triggering the hold-over claim took place. Once accepted by HMRC, a hold-over relief claim cannot be withdrawn.

Section 260 hold-over relief triggered by immediate IHT charge

TCGA 1992 s 260 provides for holdover relief in circumstances where an individual or trustee disposes of any chargeable asset (not limited to business assets) and the disposal gives rise to an immediate IHT charge (or would do so but for certain exemptions). Section 260 relief operates in a similar manner to s 165 relief and any gain arising on the disposal of the asset is 'held over' until a subsequent disposal by the transferee.

Section 260 applies in priority to s 165 and can act as a 'catch all' if the assets being disposed of do not qualify for s 165 relief.

Exclusions and clawback

If the transferee is not UK tax resident at the date of the gift or is deemed tax resident elsewhere as a result of a double tax treaty with the UK, hold-over relief will not apply (save for certain gifts of direct or indirect interest in UK land to non-residents; see TCGA 1992 s 167A).

Relief under s 260 is not available for potentially exempt transfers (for example, a lifetime gift from one individual to another). A gift to a settlement falling within one of the specified categories set out in IHTA 1984 (for example, an immediate post death interest trust, a transitional serial interest trust, or a disabled person's interest trust) will also not be eligible for hold-over relief under s 260 as the gift will not trigger an immediate IHT charge.

Subject to limited exceptions, relief under s 165 or s 260 may be clawed back if the transferee ceases to be UK tax resident in the six years following the disposal/gift of the asset. If relief is clawed back, any gain is deemed to have accrued immediately prior to the cessation of UK residence (but is reduced to the extent that the held over gain has already been taken into account in a disposal by the transferee (for example, a prior part disposal)).

(See case study 2.)

Case study 2: Settling HG Ltd shares into trust – CGT considerations

A transfer of Helen's shares to the trustees of a discretionary trust during her lifetime will be a chargeable disposal for Helen. Whether holdover relief is available will depend on whether Helen retains an interest in the trust.

If the trust is a settlor interested trust (for example, if Helen, her spouse or her minor children are beneficiaries or have not been expressly excluded from benefiting from the trust), the gift of shares will still be a chargeable lifetime transfer for IHT purposes, but holdover relief will not be available under s 260 or s 165.

If the shares are sat at a significant gain and Helen wishes to benefit from the trust, in these circumstances, Helen may wish to reconsider settling her shares into trust.

Looking forward

Succession planning should be given ongoing consideration throughout the life cycle of the business and as the personal circumstances of the shareholders change and evolve. Advisers should encourage their clients to periodically review the availability of BPR where appropriate, consider lifetime giving and their plans for managing their interests once they are no longer able to, or are no longer around, to do so themselves. ■

The next guide in this series will consider practical considerations and tax reliefs available to investors when financing the business.

For related reading visit www.taxjournal.com

- Lifecycle of a business: setting up (Helen Cox & Gemma Grunewald, 27.6.19)
- IHT review: reform of business property relief (Ashley Greenbank, 30.7.19)