



The September Fest 2020

Tax Stream

Succession Planning for Owner Managed Businesses

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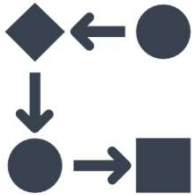
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Today's presentation

- Succession planning
 - Examine:
 - Retirement relief and business relief
 - Work through a number of examples
 - Recent TAC cases
 - Share buybacks

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Recent developments

- Covid-19 – seeing accelerated succession planning:
 - Significant drop in asset values in certain sectors:
 - Commercial property
 - Trading companies valued on an earnings basis
 - Negative economic climate
 - Reduced values = reduced tax
- Fear of increased capital taxes in the future or a wealth tax
- A lot more Will planning

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Retirement relief – main conditions

- Relief from CGT on the disposal of certain business assets
- Investment assets do not qualify for relief
- Individual 55 years of age or above
- Subject to a tax avoidance provision – must be a bona fide disposal not to avoid tax



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Retirement relief – main conditions

- Two forms of retirement relief, disposal to third party (s598) and disposal to child (s599 – requires a claim)
- €750k lifetime consideration threshold (€500k -66 y.o.a +)
- Relief can be clawed back if proceeds exceed €750k/€500k (watch inter-spousal disposals)
- No upper limit on disposals to child for under 66 y.o.a
- Relief is €3m on disposal to child for 66 y.o.a +
- Relief clawed back if child disposes of assets within 6 years – CGT paid by child

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Retirement relief -recent TAC case

- Case 140 TACD 2020
- Covered the interaction of s598 and s599
- Asset disposed of to child – relief availed of under s598
- Asset sold within 6 years by child
- Revenue contended that relief was claimed under s599 due to ticking the “within the family” box on Form 11
 - Result = clawback of CGT on the child
- TAC held that taxpayer availed of relief under s598
- TAC - if clawback arose under s599 that s598 would then have applied to negate it

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Retirement relief – sole trade type asset

- Must be non-investment asset e.g. farm or a shop
- Held at least 10 years
- Used for trade etc throughout the 10 years up to disposal
- Goodwill
 - Qualifies on non-connected sales
 - Bona fide test on sale to connected company
 - "Reasonable to consider" no tax avoidance motive for sale
- Interspousal transfer and subsequent claim for RR?
 - Lifetime transfer – only period of ownership transfers
 - On death – period of ownership and period of use transfer
- Leased farm land – see Revenue Operational Manual 19.06.03
- TAC – shares in a milk co-op for dairy farmer?

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Retirement relief – recent TAC case

- Case 156 TACD 2020
- Retirement relief claimed on land let on "conacre"
- Land had been let for a good number of years and disposed of to 3rd party in 2017
- Conacre found not to be farming
- Appellant failed to provide evidence that she used the land for the purposes of farming
- Relief denied



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Retirement relief – shares in a company

- Must be a family company – decided by voting rights
 - 25% of voting rights, or
 - Not less than 10% with family holding not less than 75%
- Shares held at least 10 years
- Director at least 10 years with at least 5 years FT working
- Interspousal transfer and subsequent claim for RR?
 - Lifetime transfer – only period of ownership transfers
 - On death – period of ownership and directorship transfer
- Company must be wholly or mainly trading throughout 10 years up to disposal (groups can qualify)
- Wholly or mainly test – look at it in the round
- Investment assets water down the relief available

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Retirement relief – shares in a company

- Company must be wholly or mainly trading?
- Look at it in the round!
- What are the tests (non-legislative)?
 - Income from non-trading activities;
 - The asset base of the company;
 - Expenses incurred, or time spent, by directors/employees;
 - The company's history;
 - Balance of indicators – what else is indicative?
- No one test is conclusive
- Exceptional cases can be difficult e.g. personal service companies with large investment assets

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Retirement relief – shares in a company

- Once wholly or mainly trading is established, what then?
- Look at the impact of investment assets on retirement relief
- Formula for calculating level of relief available

Chargeable business assets
Total chargeable assets

- See next slide and example on page 11 of Revenue guide to retirement relief

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Retirement relief – shares in a company

Sample balance sheet (at market value)			
		€	
Assets			
Trade buildings/land		500,000	CBA
Plant/machinery		200,000	CBA
Cash (Euro)		750,000	NCA
Debtors		300,000	NCA
Stock		250,000	NCA
Quoted shares		10,000	CA
Goodwill		1,000,000	CBA
Investment property		500,000	CA
		3,510,000	
Liabilities			
Creditors etc		2,700,000	
MV of shares		810,000	
Formula		1,700,000	CBA
		2,210,000	CA+CBA
Relief upon value of		623,077	

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Retirement relief – FA 2017 changes

- FA 2017 changes:
- Disposal to connected company now subject to bona fide test
- "Reasonable to consider" bona fide disposal not for tax avoidance
- RR to 3rd parties and RR to child can now aggregate where:
 - Parent makes a disposal of shares to child, and
 - Makes a disposal of shares to a company controlled by that child, and
 - The parent is 66 years of age or above
- Effect of this provision is to potentially exceed the RR to 3rd parties threshold of €500k (66 YOA)
- This gives rise to a charge to CGT or a clawback of the relief
- Impact on share buybacks?

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Retirement relief – FA 2017 changes

Example

- Tom (55 y.o.a) owns 100% of the share capital of Company A
- Tom and Company A satisfy the conditions for RR
- Tom sells his shares in Company A to his son's company, Company B, for €700k
- Post the sale Tom is still connected to Company A
- Does he qualify for RR?
- Position is now uncertain
- Sale must be bona fide and not for tax avoidance
- Aside from this – big question now is IT or CGT following FA 2017 changes to s135 TCA

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Retirement relief – FA 2017 changes

Example

- Tom owns 100% of the share capital of Company A, it is valued at €1m
- Tom is 66 YOA
- Tom and Company A satisfy the conditions for RR
- Tom gifts €500k of his shares in Company A to his son – avails of RR on disposal to child s599
- Tom sells the balance of his shares in Company A to his son's company, Company B, for €500k
- For the purposes of 3rd party RR Tom's proceeds from sale aggregate with the gift – total €1m
- Result is that €500k RR threshold breached and no RR on disposal to Company B
- RR still available on gift – could ER apply to soften the blow?

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Retirement relief – Example 1

- Paul is 54 YOA, he holds 100% of the shares in his trading company P Ltd
- P Ltd is worth say €1.5m
- Paul's wife has been a director of P Ltd for at least 10 yrs and worked on a full time basis for at least 5 yrs
- Paul wishes to liquidate P Ltd in the coming yrs and maximise the RR available
- Paul should transfer 50% of the shares to his wife before reaching 55 – aggregates from 55 onwards
- Period of directorship does not transfer with gift of shares to spouse – not needed she was a FT director
- Period of ownership does transfer
- Result is tax free €1.5m from company rather than €750k

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Retirement relief – Example 2

- Simon was 70 YOA, he held the entire share capital of S Ltd
- S Ltd was worth say €400k
- Simon held the shares for 10 years and was a full time working director of the company etc
- Simon died and the shares transferred to his spouse Karen
- Karen was appointed as a director when Simon died and ran the company
- She sold it 1 year later for €500k – does she qualify for RR?
- Yes – on death period of ownership of shares **and** period of directorship transfer to spouse
- In any event, capital gain only €100k

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Example 3 – inter-spousal disposal

- Derek sold his company for €750k two years ago
- Retirement relief was claimed and CGT of €250k was saved
- Derek also has a farm worth €1.2m, he has farmed the land for 10 years
- Derek transfers half the farm to his spouse Karen, what are the tax consequences?
- No taxes on transfer between spouses, but
- Disposals between spouses aggregate for retirement relief purposes
- Derek regarded as receiving €600k on asset eligible for retirement relief
- Effect – earlier relief of €250k clawed back
- Clawback would also occur if Derek sold land to third party

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Example 4 – €3m parent to child cap

- Pat is 66 and holds 100% of a trading company Cup Ltd
- Cup Ltd is worth say €6m (assume no base cost)
- The conditions for retirement relief are satisfied
- Pat wishes to gift shares in the company to his son
- Pat is 66, €3m cap applies = CGT of €990k (€6m-€3m)*33%
- Early action would have saved €990k!
- Future disposal when 66+ does not aggregate with a disposal pre 66 for the purposes of the €3m cap

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Business asset relief – main conditions

- Applies to gifts/inheritances of qualifying business assets
- Affect of relief is 90% abatement in taxable value of the gift
- Business must be valued at over €3.35m for CAT charge to kick in for child (group A threshold €335k)
- Does not apply to investments assets e.g. rental property (but forestry can qualify – recent Revenue e-Brief)
- No age requirement unlike retirement relief
- No relationship requirement
- Assets must have been held by disponent for 2 years for inheritance and 5 years for gift

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Business asset relief – main conditions

- For companies – control of 25% of voting, or family control or if employee 10% of share capital
- Relief can apply to assets owned personally and used by trading company
- Subject to clawback if recipient makes disposal within 6 years
- Relief also clawed back if business is no longer carried on
- Reinvestment within 1 year can avoid the clawback if business asset is sold
- Can apply to farm assets (perhaps not hobby farm assets though nor to farmhouse)

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Excepted/excluded assets and BAR

- Excepted/excluded assets held by a company do not qualify for relief, for example:
 - Rental properties (most)
 - Quoted shares
 - Assets held by company not used for the business e.g. a boat
 - A new business acquired within the 2/5 year hold window
 - Expansion organically is ok for relief, expansion by acquisition not so
 - Non-working capital cash
- Excess cash is a contentious area – how do you prove excess cash is required for the business?

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Excepted/excluded assets and BAR

- No Revenue guidance on how to determine surplus cash
- Was the cash used for the business?
- Was the cash used to finance the business carried on by the company?
- How much cash did the company use regularly?
- What were its short-term cash requirements?
- Does the amount of cash fluctuate?
- Cash earmarked for business use can qualify
- Barclays Bank Trust case (UK case) provided a rule of thumb that cash = circa 25% of turnover should be ok
- Rule of thumb not tested in Ireland

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Business asset relief – simple example

- Assume inheritance of shares in a qualifying company
- Inheritance by child of disponer

	€		
Company value	2,000,000		
Assets of company			
Buildings	1,000,000		
P&M	10,000		
Stock	800,000		
Cash	400,000	Assume all WC	
Rental property	100,000		
	2,310,000		
Liabilities			
Creditors	310,000		

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Business asset relief – simple example

- Value of rental property does not qualify for relief

	€
Value of shares	2,000,000
Less non-qualifying assets	100,000
Qualifying for BAR	1,900,000
Relief @ 90%	1,710,000
Net after relief	190,000
Add in non-qualifying assets	100,000
Taxable	290,000
Less Group A threshold	335,000
Taxable	Nil

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Succession planning – Example 1

- Trading company good asset mix

Sample balance sheet	€
• Fixed assets	1,500,000
• Debtors	1,000,000
• Stock	1,000,000
• Cash	500,000
• Total assets	4,000,000
• Total liabilities	500,000
• Net assets	3,500,000

- Assume company value is €3.5m – parent to child transfer of entire shareholding, parent 60 YOA

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Succession planning – Example 1

- Retirement relief available – no CGT
- CAT analysis

	€
• Value of company	3,500,000
• Less stamp duty	35,000
• Taxable value	3,465,000
• BAR	(3,118,500)
• Taxable gift	346,500
• Group A threshold	(335,000)
• Excess	11,500
• Less small gift exemption	(3,000)
• Taxable amount	8,500
• CAT @ 33%	2,805

- In most cases very little CAT to be paid
- Stamp duty would be more costly (€35,000)

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Succession planning – Example 2

- Trading company holding investment assets/excess cash
- Sample balance sheet

	€
• Fixed assets	200,000
• Debtors	2,000,000
• Stock	1,750,000
• Investment assets (e.g. shares/rental)	200,000
• Cash	<u>2,000,000</u>
• Total assets	6,150,000
• Total liabilities	<u>3,000,000</u>
• Net assets	3,150,000
- Assume company value is €3,150,000 – parent to child transfer of entire shareholding, parent 60 YOA
- Assume company is wholly or mainly trading

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Succession planning – Example 2

- Impact of investment assets on retirement relief for parent
- Formula for calculating level of relief available

Chargeable business assets
Total chargeable assets

€200,000 (fixed assets)
€400,000 (fixed assets + investment assets)

- Result is that only half of the value of company eligible for relief
- CGT liability could be €520k! (assumes ER does not apply)

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Succession planning – Example 2

- Solution for CGT in this case would be to convert the investments into non-chargeable assets – e.g. sell the investment for cash/debtor
- Possible to sell to shareholder/connected company and buy back at later date
- Obvious costs would be CGT and stamp duty

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Succession planning – Example 2

- Main issue in this case for BAR purposes is the investment assets and excepted assets (excess cash)
- Excess cash is a contentious area – how do you prove excess cash is required for the business?
- Often looked at in hindsight as with all audit cases
- In this case assume that €500k is working capital

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Succession planning – Example 2

- Impact of investment assets on business asset relief (ignore stamp duty for this example):

	€
• Value of company	3,150,000
• Less excepted assets	<u>1,700,000</u>
• Eligible for BAR	1,450,000
• BAR	(1,305,000)
• Add excepted assets	<u>1,700,000</u>
• Taxable gift	1,845,000
• Group A threshold	<u>(335,000)</u>
• Taxable amount	1,510,000
• CAT @ 33%	498,300

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Succession planning – Example 2

- Lack of full analysis and planning can lead to adverse tax consequences
- Big problem would actually be funding the liabilities
- In this case tax liability would be circa €520k overall (due to CGT/CAT offset)
- Tax would often be doubled due to the need to withdraw funds from the company to pay the tax (i.e. income tax cost)
- Total tax cost on the transfer circa €1m – not a happy client!

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Company share buyback

- Excellent opportunity to tax efficiently extract cash from company in non-aggressive fashion
- Normally when company buys back shares = income tax on excess above subscription price
- Share buyback relief allows CGT treatment
- Possible to extract up to €1.5m with retirement relief in some family situations or €2m at 10% with ER
- Most common use is in succession planning
- Much more relevant following FA 2017 changes to s135 TCA - distributions

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Company share buyback (main conditions)

- The company must be a trading company
 - Cant be trading in land, shares etc
- The shareholder must be both resident and ordinarily resident
- The shares must be held for at least five years (some exceptions)
- Buyback must be for the benefit of the company's trade (pre-approval from Revenue??)
- Tax briefing 25 sets out what qualifies –
 - Succession planning
 - Withdrawal of equity finance
 - Disposal by executors/legatees

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Company share buyback (main conditions)

- Expected to resign as a director (unless handing over for short period of time) – recent TAC case
- 3 shareholding/capital tests
 - Substantial reduction in shareholding required (25% reduction)
 - Shareholder must no longer be connected with the company (30% of capital)
 - Revenue want almost complete disposal
- Spouses shareholdings aggregate for the tests
- Company must have adequate distributable reserves
- Company must pay for shares – cant be left outstanding

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Tax Appeal Commission

- Appeal case no 22 2017 relating to share buybacks
- Taxpayer simultaneously gifted shares and undertook company share buyback
- Not possible for the taxpayer to say accurately what occurred first, the gift or the buyback
- If the buyback occurred first legislative requirements of share buyback would not be satisfied
- Commissioner satisfied that the intention of the taxpayer was to transfer shares to children and dispose of shares
- Found in favour of the taxpayer
- Taxpayer after buyback held 30% of shares and remained on as Chairman – no issue

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Company share buyback (example)

- Sean and Alison hold 1 share each in the share capital of their company ABC Ltd
- ABC Ltd is worth say €2m
- Sean and Alison wish to transfer the company to their son Sam but also extract say €1.5m
- Sean and Alison to retain some shares (sentimentality)
- Share buyback represents the best way forward
- Steps (broadly):
 - Bonus issue of shares to increase share capital – say 98 shares
 - Gift of a portion of the shares to Sam – 20 shares
 - Buyback say 75 shares

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Company share buyback (example)

- Substantial reduction calculation (below 75% of pre buyback):
- Before buyback Sean and Alison hold 80% of ABC Ltd
- Post the buyback they hold 20% (5 shares out of 25)
- Connected party test (less than 30% of capital) –satisfied



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Questions?

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