FSPG
CHARTERED ACCOUNTANTS

KEY GUIDE

Starting and selling a business

Planning for the long term

Business confidence is being affected by mounting concerns about the impact of Brexit, making it more important than ever to carefully plan out any new business venture.

When it comes to selling a business, you may be surprised at how early you need to start thinking about this – maybe before the business has even started. It doesn't matter whether you are developing a business idea to quickly cash in before starting all over again (the typical serial entrepreneur), planning a smart career move (with the successful sale of a self-started business looking very good on your resumé) or are in for the long haul, planning your exit strategy at an early stage will ensure you don't pay more tax than necessary.

Starting a new business

Some of the decisions and actions that you take when starting a business can have significant effects for some time. The foundations you put in place at the outset are very important and can affect the business's survival. With careful planning and good advice, starting your own business may prove to be one of the best steps you ever take.

First you need to research and develop your business idea, and review the market for it. Market research can be as basic as asking your friends and colleagues what they think, or as sophisticated as employing a market research agency.

Planning point

If feasible, test your product or services on a small scale by working part-time around your current employment before making a final decision.

Your business plan

The next stage is to prepare a business plan. This should describe the business, its objectives, its strategies and its financial forecasts. Every business should have a business plan but it is especially important at the beginning. A good plan is essential if your business needs external funding such as bank finance, but equally importantly it will allow you to measure how well your business is doing once you start trading.

The financial projection is particularly important, because this will cover pricing and costs, sales and profit forecasts, how much capital you will need and projected cashflow statements for the first three to five years. If you start with insufficient capital, your business may be dead in the water before it even begins.

The initial financial projection will not be much more than an educated guess without any track record to base it on, and its accuracy will depend on how much research you have done. One way to deal with the likely inaccuracy of the initial projection is to prepare figures based on best- and worst-case outcomes. Once you start your business, you should keep updating your financial projection and, because it will then be based on actual figures, it should become increasingly accurate.

Finance and grants

Despite its limitations, your financial projection should give you an idea about how much finance you will need. Having adequate finance is probably going to be the biggest hurdle for many people starting a new business. The obvious starting point is your own savings (but be careful of the capital gains consequences, if cashing in investments) and loans from family and friends.

If you do not have a track record in business, you might have to remortgage your home. Despite the introduction of tighter lending requirements, it is still possible to arrange

deals and, although arrangement fees can be quite high, interest rates continue to be relatively low even with last November's doubling of the Bank Rate to 0.50%. However, some lenders will not permit remortgaging for business investment purposes.

In some cases, a bank overdraft or business loan may be available, and there are specialist loans such as a loan of up £5,000 from the Prince's Trust for young people aged 18 to 30. The British Business Bank (funded by the Department for Business, Energy and Industrial Strategy (BEIS)) administers several programmes aimed at smaller businesses, including start-up loans (up to £25,000) with fixed interest rate of 6%) and the Enterprise Finance Guarantee Scheme (75% of a loan from a bank or other financial institution is guaranteed). Other possibilities include commercial mortgages (useful if you are buying business premises) and grants (available from various sources). A more recent development is the availability of online financing such as peer-to-peer lending and crowdfunding.

Other issues

If you intend to trade through a company, you might have the choice of raising finance either by issuing share capital (equity) or by taking a loan (debt).

- Equity finance means that you will be bringing in outside shareholders, who may want a role in deciding how the company is run. Because shares can be sold, you could end up with a troublesome outside shareholder. There is no requirement to pay a dividend on equity, although if you pay yourself a dividend then the same rate of dividend will be payable to the outside shareholders.
- Debt finance allows you to retain complete control of the business, although ultimately the debt will have to be repaid. You will also have to pay interest on the debt even if your company's business is suffering a downturn.

Planning point

Rather than running the business alone, consider the benefits to having a partner or bringing in a co-shareholder. It's a good way of obtaining complimentary skills – for example, you may be good at developing the business but lack sales, marketing or financial skills.

Of course there can be benefits to bringing in a co-shareholder, or having a partner instead of running the business alone. It's a good way of obtaining complimentary skills – for example, you may be good at developing the business but lack sales, marketing or financial skills.

Which business entity?

Many start-ups are as a sole trader because this is the simplest, most flexible, business structure. Running your business as a sole trader can result in paying more tax compared to trading as a limited company, but the position is not as straightforward as it was before. This is because the basis of taxing company dividends changed from 6 April 2016, making the withdrawal of profits from a company by way of dividends a much less attractive proposition.

Example – Tax cost of different business structures

Samantha is currently self-employed, with annual profits of £75,000. For 2017/18, her total tax and national insurance contributions (NIC) will be £22,763. If she had instead run the business as a limited company – withdrawing £8,000 as director's remuneration, with the remaining profits taken as dividends – the tax cost could have been reduced to £20,480. The tax saving may not be considered sufficient compensation for losing the simplicity and cost savings of operating as a sole trader. The reduction to the dividend allowance from £5,000 to £2,000 from 6 April 2018 will further reduce any advantage of incorporation.

There are advantages and disadvantages to a limited company structure. You may find it easier to raise finance, but there is more administration involved and your financial statements are available for anyone to look at – at least in an abbreviated form (even less information needs be reported if your company qualifies as a micro-entity). In theory, a company offers personal protection from your business debts. However, this protection is reduced if you must give personal guarantees. It is much easier for your family, relatives and others to become involved in the running of the business given a company structure (they can be made directors without you losing any control), and some suppliers and lenders prefer to deal with a company.

Sometimes it is best to start off as a sole trader or partnership and incorporate later. This can be beneficial if you expect your business to take a while to become profitable, as losses from a sole trader business or partnership can be offset against your other income for the previous three years. It is more difficult to change business structures in the opposite direction.

Planning point

Consider leasing the equipment you need rather than buying it outright. Leasing can be more tax-efficient and leasing high value items, such as cars, will be much healthier for your cash flow during the first few years of trading.

Where two or more people are in business together, a partnership may be preferable; although partners need to be sure they can work happily together. There is also the choice of trading as a limited liability partnership (LLP). Members of an LLP are normally taxed in the same way as partners in a partnership, but in other aspects an LLP is more like a company – the main advantage being one of limited liability.

When it comes to premises and equipment

You want premises that enable you to operate effectively but without any unnecessary costs. You also need to consider the future – you don't want to be tied to premises that might be unsuitable when your business grows. The main choices are:

- Working from home – maybe a spare room or a cabin in the garden.
- Renting – this usually has minimum upfront costs and your rent is a tax-deductible expense.
- Buying outright or taking a long lease.

Whether you are renting, buying or leasing business premises, make sure you budget for all the related costs. Business rates can be a substantial cost, so make sure you apply for small business rate relief if you qualify (100% relief applies where the rateable value is less than £12,000). Then there will be the costs of adapting premises to your business's needs. If renting or leasing, do not forget to allow for services charges. They can often be surprisingly large in relation to the rent.

High overheads have resulted in many business failures and you must be particularly careful if your business is seasonal – the costs will continue despite a reduced off–season income.

If you are taking a lease on a property, an important decision will be whether to agree a short or long-term lease. A longer term will give you security, but it means you might be stuck with the lease if the business fails.

Tax relief for buying equipment is provided through the system of capital allowances. These give tax relief in the year of purchase or spread it over several years.

Registering for taxes

If you are in business as a sole trader or partnership, you will need to register with HM

Revenue & Customs (HMRC) as soon as you start working for yourself. The payment of NICs will entitle you to the state pension and some other benefits. HMRC is usually aware of new limited companies and should contact you. As a director, both you and your company will pay NICs on your remuneration from the company. Your contributions will entitle you to the state pension and contribution-based benefits, such as jobseeker's allowance. Your company's contributions will be reduced, maybe to nil, by the annual £3,000 employment allowance (although this is not available if you are the company's sole employee).

You must register for VAT if your sales exceed the registration threshold, which is fixed at £85,000 until April 2020. Sometimes it is a good idea to register for VAT even if your turnover is below the threshold, so that you can recover the VAT that you are charged on your purchases. There are some special schemes for small businesses, such as cash accounting and the flat rate scheme, as well as schemes for retailers and some other types of business. Choosing the right scheme can simplify your VAT administration and may produce VAT savings.

Planning point

The reporting requirements can make running payroll quite difficult, especially if you are not altogether comfortable using a computer. You might therefore decide to outsource your payroll function, allowing you to remain focused on running your business.

Example – Choosing the right VAT scheme

Richard is self-employed. His VAT-inclusive annual sales are £95,000 and he purchases goods for £20,000. Using the normal basis of calculating his VAT liability, Richard pays annual VAT of £12,500 ((£95,000 – £20,000) x 20/120). If he had used the flat rate scheme, then the VAT liability would be reduced to £9,975 (£95,000 x 10.5% (the flat rate relevant to Richard's business)). However, the cash advantage obtained by using the flat rate scheme has been removed for low-cost, service-related businesses from 1 April 2017.

Employees

You might start off doing everything yourself, but when your business grows you will probably need to employ staff. Employers must deduct tax and NICs from employees' pay under the Pay As You Earn (PAYE) system. You will have to register with HMRC as an employer and run payroll software that reports real time PAYE information to HMRC whenever you pay your employees.

Other important staffing issues include training and improving staff performance, the national living wage (the national minimum wage applies to employees aged under 25 and apprentices), employee rights, health and safety, and the provision of a workplace pension into which your employees must be automatically enrolled.

Your online presence

It is becoming increasingly important for a new business to have an online presence. At the very least, this means having a website to promote and market your business, and with online selling you can reach customers worldwide. The government provides resources and advice for small businesses under its *Do More Online* campaign.

Selling your business

There are a variety of tax consequences to selling your business, and these will depend on whether you sell for cash, receive shares or loan notes in exchange for your business, or a mix of each. One popular arrangement is the 'earn-out' where the final sale price is based

on the future performance of your business following its sale – typically over a three to five-year period. With an earn-out, you remain involved in the business and will have to 'earn' the deferred proportion of the sale price.

If you are selling a company, you will have to decide whether to sell the company itself (your shareholding) or the company's business and assets. Not surprisingly, what suits you as a seller will usually not suit the buyer. For example, you will no doubt prefer to be paid in cash, but the purchaser (if the sale is to a company) may offer shares or loan notes. If you are selling then you will probably want to sell the company, but a purchaser may prefer buying the business and its assets, which is a far simpler arrangement from their point of view. If the purchaser takes over the company then they also take over any hidden liabilities.

Planning point

You need to establish whether or not entrepreneurs' relief is available well in advance of a sale. If your company has more than 20% of non-trading activities, income or assets, then it might not qualify as a trading company, but it may be possible to rectify this situation prior to the sale.

The most important tax consideration is usually whether or not entrepreneurs' relief is available as this reduces the rate of capital gains tax (CGT) to just 10%. However, with a higher rate of CGT of just 20%, the cost of not qualifying for entrepreneur's relief is not as onerous as it once was. The tax situation can be particularly complicated if you sell the business and assets out of a company. Your company will pay corporation tax on the gains that arise from the disposal. You then have the problem of extracting the proceeds from the company, and this can result in a double charge to tax.

Capital gains tax

You are likely to pay CGT when you sell a successful business, so it is important that you meet the qualifying conditions for entrepreneurs' relief whenever possible:

- If you run your business as a sole trader or as a partnership, then entrepreneurs' relief will apply for any assets used for business purposes. You must have run the business for at least one year to qualify.
- If you run your business as a company, entrepreneurs' relief will be available provided the company is a trading company, your shareholding is at least 5%, and you are an employee or director. The one-year rule applies to all three conditions.
- Relief may also be available for associated disposals. This is where you personally own assets which are used by your company or by a partnership if you are a partner.

There is currently a lifetime limit of £10 million of qualifying gains, so this will cover all but the very largest of disposals.

If the disposal (or some aspect of it) does not qualify for entrepreneurs' relief, then gains are taxed at the rate of 10% up to the level of your basic rate income tax band, and at 20% thereafter.

Calculating gains

Where you are disposing of a sole tradership, then gains will be calculated separately on each chargeable asset. These assets are mainly land and buildings, and intangible assets such as goodwill and trademarks. Goodwill is the difference between the total sale price and the value placed on the net assets of the business (assets minus liabilities). The same principle applies if you are selling the business and assets of a company except that the company will be subject to corporation tax rather than CGT. If you are selling your company, then CGT will be charged on the gain on selling your shareholding. This is broadly the sale proceeds minus what you paid to buy or subscribe for the shares.

In a partnership, each partner owns a share of each of the business assets. Therefore, the sale of a partnership's business will mean that a partner is liable to CGT on the gain arising on their share of each asset.

Earn-out

With an earn-out, part of the sale proceeds will be deferred. The actual amount you will ultimately receive will not be known at the time of sale, so an estimated market value must be included in the proceeds figure representing the right to receive future payments. If the amount subsequently received is higher, then the additional proceeds will be treated as a separate disposal. However, where part of the proceeds is payable later but this amount can be established at the time of sale, you will be treated as making just the one disposal. Since CGT will then be payable before some of the proceeds are received, you may be able to pay tax by instalments.

Sale of a company's business and assets

Sometimes a purchaser will not want to buy your company, but will instead prefer to buy the company's business and assets. The purchaser may have good commercial or tax reasons for wanting to take this route, although this type of sale is likely to result in a higher tax cost for you. This is because the company first pays corporation tax on the sale of the business assets, and then you will have to pay income tax or CGT when withdrawing the sale proceeds from the company.

Planning point

With an earn-out, you must 'earn' part of the purchase price based on the future performance of your business following the sale. Professional advice is especially important with this type of arrangement.

Should you accept shares or loan notes?

You will probably prefer to sell your shareholding for cash, but the purchasing company may offer shares or loan notes – or the proceeds may be a mix of each. Taking shares or loan notes is riskier than a sale for cash because securities can fall in value, and unquoted shares can be very difficult to sell. There is also the possibility that the purchasing company will fail. Whether you decide to accept securities will depend on your bargaining position (i.e. how desperate are you to sell) and whether the sale price is higher than that for a cash sale.

One major advantage of taking securities is that you will not have any immediate CGT liability. The gain on the disposal of your shares will be rolled over until the replacement securities are disposed of. You may be able to make use of several years' annual CGT exempt amounts, but in some cases you will lose the benefit of entrepreneurs' relief.

You might receive securities on the sale of a business run as a sole tradership or partnership. This does not, in itself, defer your CGT liability, but you could obtain CGT deferral by incorporating your business before it's sold.

Capital gains tax planning

It is important to take professional advice either at or before the start of the sale negotiations. This may allow you to make a deal that reduces the amount of gains liable to tax.

You can make use of your husband's/wife's or civil partner's annual CGT exempt amount by transferring assets to them before the sale. If the disposal (or some aspect of it) does not qualify for entrepreneurs' relief, you can also make use of your husband's/wife's or partner's basic rate income tax band so that gains are still taxed at 10% rather than 20%.

Reinvesting your gains in shares that qualify under the enterprise investment scheme (EIS) will defer your gain until the EIS shares are sold, while reinvesting in shares that qualify

under the seed enterprise investment scheme (SEIS) will exempt a proportion of the gain. However, both types of investment are relatively high-risk.

Other tax implications

Selling your sole tradership is likely to affect your income tax position for the year of disposal. Your income may be lower because you do not have a full year's profits, or it may be higher because the assessment rules mean you are taxed on more than a year's profits in the final year of trading – which can happen if your accounting year is not the same, or nearly the same, as the tax year. In this situation, however, 'overlap profits' may have arisen when your business started and these can reduce the amount taxed on the sale.

If you sell business equipment on which you have claimed capital allowances you may have a balancing allowance, which will reduce your taxable profit, or you may have a balancing charge, which increases it.

You will not have any VAT to pay on the sale of your business if it is sold as a going concern. For this treatment to apply, the buyer must be registered for VAT and use the assets in the same kind of business that you are selling to them. If the going concern conditions are not met, then you will have to pay VAT on those assets where you have claimed VAT back – stock, equipment, fixtures and fittings and possibly property. There is no VAT on the sale of shares in a company. This will not change as a result of selling the company's business, because the business remains in the company – so there will be no VAT consequences for the company.

Planning point

Although you might be looking forward to retirement, or just a long break from running a business, a buyer may be prepared to pay more if you stay on for a fixed period as an employee or consultant – especially if you have been a key part of the business's success.

What a buyer will be looking for

It helps if you know what a buyer is looking for and why they acquire businesses.

Buying a business has several advantages compared to setting up a business from scratch. A market for your product or service will already have been demonstrated, there will be established customers, and your employees will already have experience. It may therefore be easier to obtain finance for a business with a proven track record, and many of the problems encountered with a start-up will already have been discovered by you and solved.

It might be that the buyer wants to purchase a tangible asset you own such as your business premises, or some business attribute or asset such as a brand, intellectual property or some other technology or capacity. Your business may have the expertise that the buyer particularly wants. This could be a well-trained and motivated workforce – sales, production or management. It would then be important that the key people stay on after the purchase takes place.

Of course, in some cases a buyer may simply want to remove you, as a competitor, from the marketplace.

Preparing your business for sale

Once you know what a buyer wants, you should consider how best to make your business saleable. This will include:

- Having some years of reasonable and consistent profitability – preferably showing some growth.

- Ensuring that contracts with suppliers and customers are in order.
- Securing assets such as intellectual property.
- Checking out any threats such as potential litigation.
- Making certain that key staff are in place and are likely to remain. Ideally, it should be possible for the business to be run independently without your involvement.

You may decide to market your business yourself, but be warned that this can be more difficult than you think. The last thing you want is employees or competitors becoming aware that your business is up for sale. Advertising is the obvious initial route, and most sellers will use one of the major internet sites.

Setting the selling price will probably be the most difficult aspect of the sale. There are various models which you can use based on either your business's profitability or its assets. There is no right approach, and it may be a case of coming up with a price range rather than a specific figure.

Due diligence and warranties

Once the buyer has made an offer, you then must allow them due diligence – a period of time when they can access your books and records. The buyer will want to confirm how the business is currently performing, get an idea of what the future holds, and also identify any issues or problems which might need warranting or indemnifying. A purchaser buys a company with all its actual and potential liabilities. For this reason, the buyer is likely to request a wide range of warranties and indemnities from you, although precisely what warranties and indemnities you give will form an important part of the negotiating process.

Planning point

If you are hoping to attract a venture capitalist or private investor, then it will almost certainly be necessary to use an agent to represent you.

How we can help

We have helped businesses from start-up, through growth and onto ultimate sale. We can advise you on all the matters mentioned in this briefing and many other issues that you might encounter at any stage in the life of your business.

- When it comes to a sale, we can help you negotiate the best deal, balancing price, risk and tax.
- We can keep you aware of changes in regulations affecting businesses and smooth your dealings with HMRC.

Our aim is to help you steer clear of the hazards of business life, but we can provide expert help if you do encounter them. When you have spent your lifetime building up your business, you deserve the best deal on its sale and the best advice to help you achieve it.

This publication is for general information and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking any action on the basis of the contents of this publication. This publication represents our understanding of law and HM Revenue & Customs practice as at 10 January 2018.

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