

Wood for the trees

Nick Scull considers the pros and cons of holding an owner-managed business shareholding through a personal company.

Sometimes, trading company shares are held in a non-standard arrangement such as via shareholder personal companies of which no single one is a holding company.

This article looks at the pros and cons for holding an owner-managed business (OMB) shareholding through a personal company using a practical example. The issues that arise include managing dividends, problems with business property relief (BPR) and the impact on sale scenarios.

Clever set up

Milla and Bruce set up Fhloston Ltd some years ago to act as vehicle for selling the Zorg range of costumes and other fashion items. It has proved to be very profitable.

They agreed from the outset that they would share the profits equally, but they have very different personal circumstances. Specifically, Milla has a very comfortable level of personal wealth for her needs, so she is reluctant to withdraw large dividends from the company with the consequential dividend tax liability that would give her. Bruce, on the other hand, wants a much higher level of income from the company, and is quite prepared to pay the dividend tax.

Their accountant at the time set them up with the structure illustrated in the chart *Initial structure*.

Dividends paid by Fhloston can be received tax-free in Lelu and Korben (CTA 2009, s 931B). Milla decides to retain 'her' dividends in Lelu, while Bruce pays virtually all of 'his' to himself out of Korben.

Milla and Bruce are not otherwise connected and, assuming that they are not 'acting together' to control Fhloston, then none of the companies are associates of each

Key points

- Non-standard shareholding arrangements may affect tax outcomes for individuals and companies involved.
- Milla and Bruce established a company through two personal companies to allow tax-efficient dividend payments tailored to their individual financial needs.
- Optimum arrangement to allow Milla to set up a separate business.
- Reasons why a sale to an EOT needs a preliminary reorganisation.
- Importance of comprehensive early-stage planning when structuring corporate shareholdings.



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other for the purposes of the small profits rate of corporation tax or marginal relief.

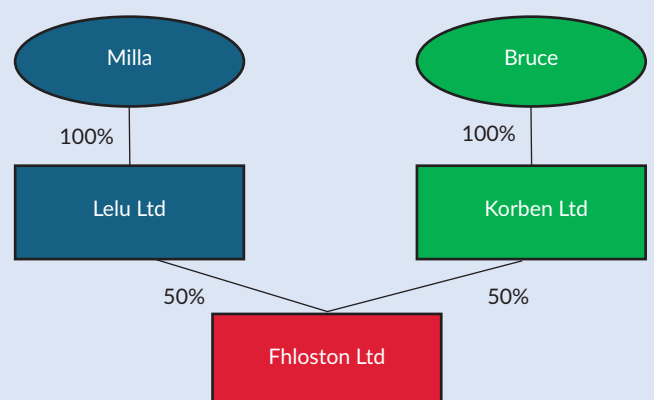
Although group relief is not available, there is scope to claim consortium relief (CTA 2010, s 153). We are told that Fhloston is very profitable, so we need not explore that aspect any further.

So, what's the problem?

Given the immediate objectives at the time, this is an excellent structure for them in many ways. There are some drawbacks to the set up though, which no doubt were explained to them at the time and accepted.

The main current drawback relates to inheritance tax, in that the shares in both Lelu and Korben will not qualify for BPR. The key point is that neither Lelu nor Korben controls Fhloston. They are not holding companies, and Fhloston is not a subsidiary. Therefore, IHTA 1984, s 105(4)(b) does not apply, and those companies' investment in Fhloston are treated as investments, notwithstanding that Fhloston itself is a trading company.

Initial structure



For completeness, it is worth noting that we do not have a problem with business asset disposal relief (BADR) for Korben. This is because TCGA 1992, s 165A(7) effectively allows us to treat 50% of the activities of Fhloston as being carried on by Korben; in practice it pays on any dividends received to Bruce and therefore has no other activities nor has it accumulated assets of its own that might jeopardise the trading status. The position is less clear cut for Lelu, and we would need to consider whether its own activities are considered substantial when tested against its 50% share of Fhloston's activities (TCGA 1992, s 165A(3)).

Time to sell

Milla has decided to start up a separate business specialising in the sale of thermal bandages, without any involvement from Bruce.

She wants to approach Bruce to see if he will buy her out of the Fhloston business, but first she asks for guidance on how this might be done tax efficiently.

A share buy back in Lelu is a non-starter here, because Milla is the only shareholder. On the face of it, it seems that there would be no problem with Korben buying Lelu's shares in Fhloston, with Lelu claiming the substantial shareholdings exemption (SSE). The consideration can be paid out over time, funded by dividends from Fhloston – a structure comparable to a more 'standard' management buyout using a new company. That would leave Milla with the choice of either continuing with Lelu as a pure investment company or reinvesting into other business activities. Milla is keen on this idea, since she could set up a new subsidiary of Lelu for the thermal bandage business and fund it with an appropriate level of debt and equity. Any prospect of liquidating Lelu is quickly discounted, including some concerns over the risk of her new thermal bandages business being seen as 'similar to' the Fhloston trade in the context of the anti-phoenixing rules in ITTOIA 2005, s 396B.

Unfortunately, some further work on the plan uncovers a problem with the SSE claim. The share capital of Fhloston was divided into A shares (held by Lelu) and B shares (held by Korben) with separate dividend rights. It seems that the intention behind this was to allow for some flexibility over dividend payments, should they decide to vary the 50/50 arrangement.

But this very point is what causes the problem, in that TCGA 1992, Sch 7AC para 8(1)(b) requires that the investing company is entitled to at least 10% of any dividends paid. We could amend the articles now (perhaps reclassifying all the shares as the same class) but we would have to wait at least 12 months before qualification for SSE can be secured (para 7).

The next best option would seem to be for Korben to buy Lelu. As noted above, Milla could well be able to claim BADR on the sale of the shares, but this is still less than ideal. Even with the benefit of BADR, if a claim is competent, she is paying 14% CGT (if her disposal is before 6 April 2026, or 18% thereafter) when the sale by Lelu would have been tax-free had it qualified for SSE.

Worse than that, the value of Lelu is well over her as yet unused £1m lifetime BADR limit, compounded by the fact that Lelu has a good deal of cash on its own balance sheet, pushing up the value further. Even though the sale would allow an

effective extraction of the cash at CGT rates (a clearance in respect of transactions in securities might be considered prudent under ITA 2007, s 701), Milla had no need or intention to extract the cash for the foreseeable future, so this just feels to her like an unnecessary tax charge.

Sell to the employees?

Milla has been reading about companies that have transitioned into employee ownership by being acquired by an employee ownership trust (EOT) and wonders whether that could be an option here. Milla's change of focus to her new business would leave something of a gap in the senior management of Fhloston, and she reckons that there are the right people already in place to step up and take over her role. This might be just the thing to secure the next generation of leadership and generally to give all the employees the chance to benefit from being part of an employee-owned company.

This option requires Bruce to be on board. This is because of the 'controlling interest' requirement (TCGA 1992, s 236M) which means that the EOT will need to have at least a 51% shareholding in Fhloston at the end of the tax year in which it acquires Milla's shares. Initial discussions with Bruce go well, and he might even decide to sell all of his shareholding as well, giving the EOT full ownership and control.

But talking of Milla and/or Bruce selling their shares to the EOT is an oversimplification. Their actual options are:

- Lelu and Korben sell their shares. There is no issue with them selling to an EOT, allowing the full benefits to the business of employee ownership, including for the employees to qualify for tax free bonuses of up to £3,600 each per year on the basis that the company is employee-controlled and the bonuses are paid in line with the conditions of ITEPA 2003, s 312A. There is no EOT relief for CGT, since that is available only to individuals (TCGA 1992, s 236H(1)(a)), presumably on the basis that SSE should be available instead. So, in this case, without SSE or EOT relief, it looks a lot less attractive an option. It would also have been less than ideal for Bruce, since he would then want to liquidate Korben and would be liable to CGT on the proceeds, thus not enjoying the main tax benefit of a sale to an EOT.
- Milla and Bruce sell their shares in Lelu and Korben to an EOT. Unfortunately, there are a number of reasons why this sale would not qualify for EOT relief. First, neither Lelu nor Korben meets the definition of a trading company for EOT purposes (TCGA 1992, s 165A does not apply here, but rather there is a narrower definition of trading in TCGA 1992, s 236I, and the same reasoning that denies BPR for IHT means that these are not trading companies for EOT purposes). Secondly, the 'all employee' condition in s 236J is tested by reference to the eligible employees of 'the company' (being a singleton company or a holding company and its subsidiaries) and cannot be met where there is more than one company owned directly by the EOT.

A neat escape

With Bruce on board, we can propose a preliminary reconstruction that will save the day and produce a much-improved outcome.

We simply need to insert a new HoldCo above Lelu and Korben, by means of a share-for-share exchange, then Milla and Bruce will be able to sell to the EOT with the benefit of EOT relief. Milla has the added benefit of an effective extraction of her cash in Lelu free of CGT.

There are some serious caveats to this advice. It is beyond the scope of this article to consider the tax issues in greater depth, but in outline these are as follows:

- We should apply to HMRC for advance clearance both in respect of the reconstruction (TCGA 1992, s 135 and ITA 2007, s 701) and in the same application request s 701 TIS clearance for the sale to the EOT. Milla in particular will have to satisfy HMRC that she does not have a main purpose in these transactions of obtaining an income tax advantage, notwithstanding that it might well be one of the main benefits (see for example Pete Miller's article '*Osmond & Allen: the sequel*' (*Taxation*, 3 July 2025) on the distinction between purposes and benefit); although in the writer's experience, HMRC is fairly accommodating on pre-EOT restructures.
- When inserting HoldCo, it should be relatively straightforward to claim acquisition relief for stamp duty (FA 1986, s 77) on whichever of Lelu or Korben is acquired first, but this will not be possible on the second. This suggests that the higher value company is acquired first (Lelu) so as to minimise the 0.5% charge on the acquisition of Korben. Alternatively, they could consider using the 'capital reduction scheme' to effect the acquisition of Korben without incurring any stamp duty.
- The structure immediately post-acquisition by HoldCo looks unnecessarily messy, and a dividend in specie of the Fhloston shares by both Lelu and Korben will tidy things up nicely. This will be free of chargeable gains (being an intra-group transfer within TCGA 1992, s 171) and there is no consideration for stamp duty purposes and therefore no liability to stamp duty.
- A mechanism needs to be found to ensure that Milla alone benefits from the cash built up in Lelu. This needs to be done in a way that is reflected in the value of the ordinary shares that Milla holds, rather than say as a debenture, such that she can bring the proceeds within the scope of the EOT relief (TCGA 1992, s 236H(1)(a)). All this detail needs to be fully disclosed in the clearance application.
- We still need to be confident that the cash in Lelu does not jeopardise the trading status of the HoldCo group for EOT relief purposes, although now it is tested against the entire activities of Fhloston.

Unlike with BADR, there is no requirement as to the minimum period by which the shareholders need to have held the shares before the sale, for the EOT conditions to be met. Nor does HoldCo need to meet the trading condition before the sale (s 236I(1)), only on the date of the sale and moving forwards.

For completeness, undertaking this preliminary reorganisation will not break the period of ownership for BADR purposes, should the sale to the EOT fall through and they revert to a trade sale or management buyout.

With hindsight

The first item on the list is to pay particular attention to any corporate shareholdings where the investee company has

different classes of shares. Issuing even a single share of a different class to another shareholder could invalidate a claim for SSE. A simple proviso in the articles of association in respect of dividend entitlement will usually be enough to fix this.

Secondly, we could have set up Fhloston with 'mixed' shareholdings, that is have Milla split her shareholding between herself and Lelu, and Bruce could have done the same re Korben. The idea here is to have different classes of shares (while still preserving Lelu's and Korben's entitlement to SSE) such that all dividends are still routed through Lelu and Korben, but the capital value is shared with Milla and Bruce as individuals.

This would have allowed the further flexibility for them to effect a tax-efficient trade sale of Fhloston, receiving some of the proceeds directly (with the benefit of BADR) and the rest being received in their personal companies (with the benefit of SSE). Even if they then decided to sell to an EOT after all, they could perhaps still do so after first undertaking a version of the above preliminary reconstruction, with all the same caveats.

Final thoughts

We all find ourselves faced with clients asking us to solve a clear and present issue, and it can sometimes be a challenge to explain to clients that they should invest in a more comprehensive review that also looks ahead at further issues that might be coming down the line, especially where they seem to be a long way off.

Most clients in start-ups are limited on their initial budgets and some might even wonder whether we are trying to overengineer what to them seems like a simple matter. It is their prerogative, of course, to give us a limited scope of work, in which case it is crucial to ensure that we can provide evidence that the warnings were given.

Luckily, some creative thinking and well-drafted clearances can often rescue the position, as it does here for Milla and Korben, but this is not always the case. The preliminary reorganisation discussed above is likely to carry a fairly significant professional cost and possibly some stamp duty too. ●

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