The tax implications of share purchase

Synopsis: Tax implications of share purchase chronologically.

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For inheritance tax (IHT) efficiency, the agreement for share purchase will normally take the form of an option agreement. The taxation effects of the option agreement can best be explained in a chronological order:

On entering the agreement
Provided the purchase agreement is commercial between the shareholding directors, it should not give rise to any IHT or capital gains tax (CGT) implications when it is entered into even if the value specified is on a fixed or formula basis.

Provided the fixed value / formula reflects the then market value, both parties are independently advised and the valuation provisions in the agreement only last for a maximum of three years (the shorter the better) with a compulsory review taking place within the specified time (or default to an 'open market' basis of valuation), it is likely that the option would have little or no value and so little or no CGT would arise.

For IHT, the option (as an asset in its own right) would not be eligible for business relief (BPR), but, if it has little or no value, it should not give rise to any IHT problem. Professional advice is essential, and each case will depend on its own facts.

The grant of an option is strictly speaking a disposal of an asset for CGT purposes, the option is an asset (separate from the shares) for CGT. However, if the option to buy is, in effect, at a price that reflects the then market value, it should have no value and trigger no adverse CGT consequences. Professional advice is essential whenever a fixed price agreement is entered into.

Extra care needs to be taken with family companies. Where a sale / purchase is to take place and an agreement is required, it will be essential to prove conclusively that the options were granted between the shareholders (i.e. the relatives) on strictly commercial terms. With this in mind, the shareholders should each seek separate independent advice and it may be advisable in some cases to have written evidence of negotiations having proceeded on an arm's length basis.

However, if the agreement is, on its face, commercial, it is important that no associated or collateral benefits are given between the shareholders (e.g. greater pension benefits). This applies to both family and non-family businesses.

Valuation of shares on death
(i) IHT
In the case of fixed price / formula agreements, the existence of the agreement and the price stated therein will be taken into account in valuing the shares.

For example, if there is an agreed value stated in the agreement of, say, £250,000, then, provided the agreement is commercial, this will be the value of the shares for IHT purposes.

Where the agreement is based on open (fair) market value, that value will be relevant for IHT.

(ii) CGT
Broadly speaking, the value on death for CGT will be that ascertained for IHT (S274 TCGA 1992).

The value of the shares for CGT will be uplifted on death which means that all inherent gains will be effectively wiped out.

Where the agreement is at market value, the value for CGT will be that value, regardless of who inherits the share.

Where there is a fixed price agreement, then only if the shares are left in the Will of the deceased shareholding director to a person(s) other than a surviving spouse or civil partner or where the value of the deceased's taxable estate exceeds the then available nil rate band, or the shares do not qualify for BPR, the uplifted value will be that expressed in the agreement because the value of the shares will have been 'ascertained' for IHT.

Where the shares of a deceased shareholding director are left in their Will to a surviving spouse or civil partner, within the nil rate band or (as is likely regardless of who they are left to) qualify for BPR, then, for IHT purposes, there is no need to ascertain their value, i.e. no formal valuation takes place.

As a result of this, for CGT purposes, the shares will have to be revalued at open market value. This may or may not be the same as that expressed in the agreement. Where the option agreement price is effectively independently aligned to market value and reviewed frequently there should be no significant problems.

Sale following death
For IHT, provided the agreement is commercial, no IHT will be due on the sale.

Where the sale is at market value at death, there should be no further CGT implications. There could be CGT implications if there is no fixed price agreement (so that the value at death is the market value) and the sale / purchase takes place some time later, at which time the value of the shares has either fallen or risen since the death, but this is unlikely in practice.

If the sale is at fixed price, then for CGT purposes, the disposal by the personal representatives will only give rise to a chargeable gain to the extent that any specified sale price (e.g. agreed by the shareholding directors) **exceeds** the market value on death **and** then only if the value of the shares were not ascertained for IHT, e.g. if they were left to a surviving spouse or civil partner, or fell within the nil rate band, or (as is highly likely) qualified for 100% BPR**.**

In such a case...

1. if the price paid for the shares under the option agreement is **lower** than the value of the shares for CGT on death, then no CGT liability will arise, but the personal representatives will sustain a capital loss. This loss cannot be passed on to the beneficiaries under the deceased's Will;
2. if the price to be paid for the shares under the option agreement **exceeds** the value of the shares for CGT on death, then a CGT liability could arise for the personal representatives.

Business asset disposal relief (previously known as entrepreneurs' relief) may be available in respect of any gains made (please see below). It is strongly recommended that professional advice should be sought at that time by the parties.

Sale following critical illness
This will be a disposal for CGT purposes by the critically ill shareholder.

Where the critically ill vendor is a shareholder in a company, but not in any way connected with the purchaser (e.g. by virtue of close family relationship or because an individual purchaser and the vendor were acting together to control the company, or, in the case of a corporate purchaser, the vendor and others connected with them control the company) then the disposal price for calculating the capital gain will usually be that which they actually receive. This will be the value stated in the agreement. The usual CGT annual exempt amount will be available.

It should be borne in mind that whether or not a vendor and purchaser are connected is a relatively complex area and professional advice should be sought.

If the disposer is connected in any way to the purchaser (e.g. by virtue of close family relationship) then even though they may receive the value expressed in the agreement for their shares, for CGT purposes the disposer may be treated as having received the open market value.

Where the open market value exceeds the value expressed in the agreement this will mean that the CGT liability will be on a gain greater than that which the disposer has actually made. The CGT rate would be a flat 10% for basic rate taxpayers (unlikely) and 20% for higher and additional rate taxpayers.

However, business asset disposal relief is likely to be available to deliver an effective rate of 10% on (lifetime) cumulative (post 5 April 2008) qualifying gains made by the disposer of up to £1 million. Account should be taken of the possible impact of CGT on sale when assessing the level of life / critical illness cover required.

There should be no IHT implications provided the arrangement is commercial.

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