BrownButler
Chartered Accountants

A guide to
Exit Strategies for Business Owners

As a business owner, planning your exit strategy is as crucial as setting up the business itself.

Planning an exit strategy requires careful thought and preparation. Ideally, business owners should start planning their exit strategy at least five years in advance.

This timeframe allows for the thorough preparation needed to maximise the value of the business and ensure a smooth transition.

It provides ample time to improve financial records and the overall structure of the business, helping to enhance the business's attractiveness to potential buyers.

Additionally, it allows for strategic decisions to be made, such as timing the exit to coincide with peak profitability or a favourable economic climate.

Early planning can help business owners identify and prepare successors, whether they are family members, business partners, or external buyers.

Using a five-year window provides sufficient time to seek professional advice and to navigate any legal, tax, or financial complexities that may arise during the exit process.

> ***This guide, prepared by our experienced expert, aims to provide you with a comprehensive understanding of the various exit strategies available in the UK, along with their tax implications.***

While this guidance provides a useful start to preparing an exit strategy, every transaction is different, so it is best to seek professional advice tailored to your needs.

If you are looking to exit your business **– speak to us.**

Methods of exit

There are many different types of exit to consider, which will often be determined by your aims and ambitions as a business leader.

Determining which exit is best suited to your circumstances is important, but you also need to consider the tax and financial implications of each method.

To help you understand which approach is best for you, in this guide we will consider:

- Trade sale
- Earn-out
- Gifts of shares
- Company purchase of own shares
- Management Buyout
- Employee Ownership Trusts
- Succession
- Liquidation

This guide is only intended as an introduction to exit strategy and it is important to seek professional advice before deciding on your means of selling or disposing of your business.

Trade sale

This is where you sell your company to another company. Usually, they operate in the same or related markets.

Achieving the best possible market value can be challenging, however, and so it may take years of investment and business development to increase the value of your business.

The key to maximising your company's value lies in understanding what potential buyers value and strategically enhancing those areas in your business.

However, here are five things to consider that can help to increase the value of your business:

1. **Financial Performance and Forecasting:** Robust financial health is one of the most important factors that potential buyers will consider when looking at a sale. This includes a strong balance sheet, steady revenue growth, and consistent profitability. Potential acquirers will also be interested in reliable financial projections. Therefore, investing time in maintaining clear, detailed, and audited financial records, and creating realistic, data-driven financial forecasts is essential.
2. **Operational Efficiency:** Enhancing operational efficiency by streamlining processes, improving productivity, reducing waste, and managing costs effectively can significantly increase your company's value. A well-run, efficient business is more attractive to potential buyers, as it suggests a potential for higher profitability and lower risks post-acquisition.
3. **Diversified Customer Base:** A diversified customer base reduces dependency on a small number of customers and thus lowers risk. Buyers will often pay a premium for businesses that have a wide range of customers spread across different markets or sectors, as it implies stability and potential for growth.
4. **Strong Management Team:** A competent, cohesive management team that can successfully run the business after the acquisition is a valuable asset. Companies with strong leadership often command higher valuations, as it gives potential buyers confidence that the business can continue to operate and grow successfully post-acquisition.
5. **Intellectual Property and Competitive Advantage:** Ownership of intellectual property rights (patents, trademarks, copyrights), proprietary technology, or other unique assets that provide a competitive edge can significantly increase a company's value. These unique assets are hard to replicate and can offer the buyer a secure market position and the potential for higher returns.

Earn-out situations

An earn-out is a common mechanism used in the sale of a business, particularly when there is a discrepancy between the seller's and buyer's valuation of the business, or when the seller is important to the future success of the business.

In an earn-out, part of the purchase price is deferred and linked to the future performance of the business.

This means that the seller will receive additional payments post-sale if the business achieves certain pre-agreed financial targets.

While earn-outs can be an effective way to bridge valuation gaps and incentivise the seller to ensure the business continues to perform well post-sale, they also come with potential risks and complexities.

One of the main risks for the seller is the lack of control over the business after the sale. The buyer may make decisions that impact the business's ability to meet the earn-out targets, which could result in the seller receiving less than the anticipated purchase price.

From a tax perspective, earn-outs can also be complex. The timing and amount of Capital Gains Tax (CGT) due on the earn-out consideration can depend on whether the earn-out rights are classified as 'ascertainable' or 'unascertainable' for tax purposes. This classification can affect when the tax is payable and how much tax is due.

Furthermore, if the earn-out period is lengthy, there is a risk that the seller may not receive the deferred consideration, for example, if the buyer's business becomes insolvent.

Given these potential risks and complexities, it is crucial for sellers considering an earn-out to seek professional advice.

This will ensure they fully understand the implications and can structure the earn-out in a way that protects their interests.

Gifts of shares

Gifting shares is another exit strategy that business owners might consider. This approach can be particularly appealing when the owner wishes to pass the business on to family members or other individuals without an immediate financial transaction.

However, it is important to understand the tax implications associated with this strategy.

When shares are gifted, for tax purposes, the transaction is generally treated as if the shares were sold at their market value.

This means that CGT could be due on the difference between the market value of the shares at the time of the gift and their original cost.

However, relief is available known as Gift Hold-Over Relief. This allows the CGT to be deferred until the recipient of the gift sells the shares. The recipient takes on the original cost of the shares for the purpose of calculating the gain when they eventually sell.

In addition to CGT, Inheritance Tax (IHT) considerations are also important when gifting shares. If the donor dies within seven years of making the gift, the value of the shares at the time of the gift could be subject to IHT.

However, Business Relief may be available to reduce the IHT payable on shares in a family or trading company.

The rules around gifting shares, CGT, and IHT are complicated and subject to change. Therefore, it is recommended that business owners seek professional advice when considering this exit strategy. This will ensure they understand the potential tax implications and can make an informed decision about the best way to pass on their business.

Company purchase of own shares

A company purchasing its own shares is commonly used when a company has multiple shareholders and only some of the shareholders would like to exit.

This allows a shareholder to exit the business and receive a return on their investment without the need for a third-party buyer.

The shares are usually cancelled upon purchase, reducing the total number of shares, which can increase the value of the remaining shares.

From a tax perspective, the proceeds from the sale of the shares to the company are generally treated as a distribution and are subject to income tax.

However, if certain conditions are met, the proceeds can be treated as capital, meaning they are subject to CGT instead, which is typically a lower rate than income tax. This can be a significant advantage for the exiting shareholder.

However, the process of a company purchasing it's own shares is subject to strict legal requirements, including the need for the company to have sufficient distributable reserves.

It also requires careful planning to ensure it does not negatively affect the company's cash flow or financial stability.

Management Buyout (MBO) arrangements

A Management Buyout (MBO) is a form of acquisition where a company's existing management team acquires a large part or all of the company from the owner or parent company. MBOs can be an attractive option for business owners looking to retire or move on to other ventures.

One of the key advantages of an MBO is that it offers a smooth transition of the business. The management team already knows the business well, which can reduce disruption and uncertainty for employees, customers, and suppliers.

It can also be a good way to reward and motivate a loyal and hardworking management team by giving them a stake in the business.

> ***Financially speaking MBOs can be complex. The management team will often need to secure external financing to fund the purchase, which can involve detailed negotiations with banks or private equity investors.***

The management team will also need to negotiate the purchase price with the existing owner, which can be challenging given their dual role as buyer and manager.

An MBO can be structured in a way that is tax-efficient for both the seller and the management team.

For example, the seller may be able to claim Business Asset Disposal Relief on the sale, reducing their CGT liability.

The management team may also be able to receive tax relief on the interest paid on any loans used to fund the purchase.

However, MBOs also come with potential risks and challenges. The management team will need to transition from being employees to business owners, which can be a significant shift. There is also a risk that the management team may overpay for the business, particularly if they are emotionally invested in it.

Employee Ownership Trusts (EOTs)

An Employee Ownership Trust (EOT) is a form of employee benefit trust introduced in the UK in 2014. It provides a tax-efficient way for business owners to sell their company to their employees.

EOTs are becoming an increasingly popular exit strategy for business owners who wish to preserve the legacy of their businesses and reward their employees.

In an EOT, a majority stake in the company is sold to a trust, which holds the shares on behalf of the employees.

The business owner receives full market value for their shares, and the sale is entirely exempt from CGT, making it a very tax-efficient exit strategy.

One of the key benefits of an EOT is that it can provide a smooth transition and ensure business continuity. As the employees become indirect owners of the business, they are likely to be highly motivated to ensure its success.

Furthermore, EOTs can be used to provide income tax-free bonuses to employees, up to a cap of £3,600 per employee per year.

> ***However, setting up an EOT requires careful planning. The company must be able to demonstrate that it is controlled for the benefit of all employees and that no individual can extract value from the trust to the exclusion of others.***

The company also needs to be financially stable and profitable enough to buy out the owner's shares over time.

Once an EOT is established, it can be challenging to reverse. Therefore, It is essential for business owners to consider their long-term plans and seek professional advice before proceeding with this exit strategy.

Overall, while EOTs may not be suitable for every business, they can provide a viable and tax-efficient exit strategy for business owners who wish to reward their employees and secure the long-term future of their business.

Succession

Succession planning is important for business owners when considering an overall exit strategy, particularly for family-owned businesses and small and medium-sized businesses (SMEs).

Succession ensures the continuity of leadership and the preservation of the company's legacy. However, this process is not just about choosing the right successor; it also involves understanding tax implications.

Succession planning is the process of identifying and developing new leaders who can replace old leaders when they leave, retire or die. It increases the availability of experienced and capable employees who are prepared to assume these roles as they become available.

For family businesses, succession planning can be a sensitive issue, often caught up with family dynamics.

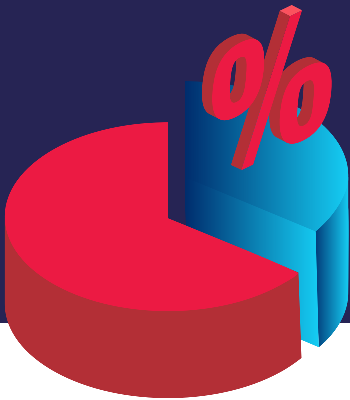
Nevertheless, the long-term survival of the business is the priority. For other types of businesses, succession planning is equally important to maintain business continuity and minimise disruption.

The tax implications of business succession can be complex and depend on the structure of the business and the method of succession. For example, business relief can provide relief from IHT on business assets. This relief can be passed on while the owner is still alive or as part of their Will.

Additionally, CGT may be due if the business assets have increased in value. However, certain reliefs such as Business Asset Disposal Relief may be available. This relief reduces the tax rate on gains on qualifying assets.

The structure of the business can impact the tax implications of succession. For example, succession in a partnership may have different implications compared to succession in a limited company.

Given the complexity of the tax implications of business succession, it's advisable to seek professional advice. A tax advisor can help to structure the succession in a tax-efficient way and ensure compliance with all tax obligations.



Liquidation

Liquidation is a form of business exit strategy where a company's operations are brought to an end, and its assets are distributed to creditors and shareholders.

In the context of a business exit, liquidation is often seen as a last resort, typically used when a company is insolvent and cannot pay its debts.

However, in some cases, solvent companies may also choose to liquidate as part of a planned exit strategy.

This is known as a Members' Voluntary Liquidation (MVL). In an MVL, the company's assets are sold, and the proceeds are distributed to shareholders.

These distributions are generally treated as capital receipts, meaning they are subject to CGT rather than income tax, which can result in a lower tax liability for the shareholders.

However, it is important to be aware of the UK's anti-avoidance rules when considering liquidation as an exit strategy.

These rules, known as the Targeted Anti-Avoidance Rule (TAAR), were introduced to prevent individuals from gaining a tax advantage by winding up companies, taking out the profits at capital gains tax rates, and then continuing the same business in a new company.

Under TAAR, if a company is wound up and within two years the shareholder who received a distribution is involved in a similar trade or activity, the distributions may be treated as income rather than capital gains. This can significantly increase the tax rate.

Business owners should consider the many different options open to them when planning an exit strategy. In any case, it is important that you seek professional advice to ensure a smooth exit and avoid tax implications.

Capital Gains on disposal of shares and Business Asset Disposal Relief (BADR)

When a business owner decides to exit their business by selling their shares, the profit made from the sale is typically subject to CGT.

This tax is calculated on the difference between the selling price and the cost of acquiring the shares. The rate of CGT can vary depending on the total amount of taxable income and gains, but for higher-rate taxpayers, it can be as much as 20 per cent.

However, to support entrepreneurs and stimulate business growth, the Government offers a tax relief known as Business Asset Disposal Relief (formerly known as Entrepreneurs' Relief).

This relief is designed to reduce the amount of CGT paid when disposing of qualifying business assets. It is particularly relevant for business owners who are selling all or part of their business.

To qualify for Business Asset Disposal Relief, certain conditions must be met.

The individual must be a sole trader or business partner or have held at least five per cent of the shares and voting rights in a company for at least two years. The company must also be trading or be a holding company of a trading group.

If these conditions are met, Business Asset Disposal Relief can significantly reduce the CGT payable. It reduces the tax rate to just 10 per cent on the first £1 million of qualifying gains over the individual's lifetime. This can result in substantial tax savings and is a significant benefit for business owners planning their exit strategy.

However, It is important to note that rules around tax and reliefs can change, and how these reliefs are applied can be complex.

Therefore, it is always recommended to seek professional advice when planning a business exit to ensure all tax implications are fully understood and any available reliefs are utilised effectively.

Advance tax clearance applications

When planning a business exit strategy in the UK, one important step that can often be overlooked is applying for advance tax clearance from HM Revenue and Customs (HMRC).

This is a service provided by HMRC that gives you certainty about the tax implications of a proposed transaction before it takes place.

In the context of a business exit, advance tax clearance can be particularly useful. Whether you're planning a sale to a third party, an MBO, setting up an Employee Ownership Trust, or any other exit strategy, there can be complex tax implications. These can include CGT, Income Tax, Corporation Tax and potentially others.

> ***By applying for advance tax clearance, you can get confirmation from HMRC about how they will treat the transaction for tax purposes.***

This can give you certainty about your potential tax liability, allowing you to plan effectively and avoid any unexpected tax bills later on.

The process involves submitting a written application to HMRC, outlining the proposed transaction in detail and explaining why you believe a particular tax treatment should apply.

HMRC will then review the application and provide a written response, usually within 30 days.

The Advance tax clearance service is discretionary and HMRC may not provide clearance in all cases. Additionally, the clearance is based on the information provided, so it must be accurate and complete.

Financial Due Diligence

Financial Due Diligence (FDD) is an important step in the business sale process.

It involves a thorough examination of the company's financial health, including its assets, liabilities, income, expenses, and cash flow.

This process helps to identify any potential financial risks or liabilities that could impact the value of the business or the terms of the exit.

It also provides a clear and accurate picture of the company's financial performance, which is essential for setting a fair and realistic price for the business.

It is likely that the potential buyers or successors will conduct their own financial due diligence, and discrepancies between their findings and the owner's claims could jeopardise the exit process.

FDD is usually carried out by a potential buyer once an offer has been agreed between seller and buyer. It allows the potential buyer to better understand the financial operation of the business and that the information they have received in making that offer has been accurate.

Due to this, conducting financial due diligence is not only important for understanding the financial state of the business but also for ensuring a smooth and successful business sale.

Here to help

Choosing the right exit strategy for you and your business can be challenging, but as our guidance indicates, it is better to plan sooner rather than later.

We have a long and successful track record of helping business owners to achieve successful and tax-efficient exits from their businesses, by providing carefully tailored advice and support.

Our expert team is here and ready to help guide you through the creation and delivery of an effective exit strategy, please contact us today.

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