

**GSCCA Practice Note on Accounting for Disposals of Shares in Local Companies which have Undistributed Income for Tax Purposes (eg Post 31 December 2007 Trading Profits)**

*Issued Jointly by the Taxation and Technical Sub-Committees*

The GSCCA Taxation and Technical Sub-Committees have issued this practice note to provide guidance on certain financial accounting and tax issues which could arise as a result of the introduction of the Zero-10 tax regime when there is a disposal of shares by local shareholders in Guernsey companies.

This practice note cannot cover all accounting or other disclosures for all eventualities and the intention is to raise awareness of the issues for the accounting profession in Guernsey.

**Background**

Members will be aware that the “Zero 10” tax regime (introduced with effect from 1 January 2008) charges tax on most post 2007 Guernsey company trading profits at the rate of 0%. Such profits fall within the definition of “undistributed income” for tax purposes. Tax legislation provides for a charge to tax to arise on locally resident shareholders on the happening of certain “trigger events” which will bring their proportion of any undistributed income into charge to tax if that income has not been subject to tax at 20% or more either in Guernsey or elsewhere. A trigger event could arise where there is a disposal of shares in a company held directly or indirectly by a Guernsey resident individual.

The disposal results in a “deemed distribution” of the undistributed profits (as computed for tax purposes) attributable to the shares being sold. The company is required to report the deemed distribution to the Director of Income Tax and pay tax at 20% on the relevant share of undistributed income attributable to the shares being sold. The tax payment to the Director of Income Tax is made by the company **on behalf of the disposing shareholder.** The disposing shareholder will be entitled to the tax credit which will be used to offset his tax liability on the deemed distribution caused by the share disposal.

The trigger event does not result in an actual distribution so that when the company subsequently pays a dividend out of profits that have been subject to tax as set out above, no further Guernsey tax will be payable either by deduction at source by the company, or in the hands of the new shareholder who purchased the shares. However, this is only the case if there has been a disposal of 100% of the shares. In any other case, only a proportion of the company’s accounting profits will have been subject to tax and further tax may be payable if any part of a subsequent distribution is made out of any remaining undistributed income for tax purposes.

**Proposed accounting treatment and model example to illustrate**

The following example illustrates the issues involved,

Vendor sells 50% of his/her 100% stake in a Guernsey company to purchaser for £50 when the balance sheet of the Guernsey company is represented by £100 of cash at the date of disposal and £100 of accumulated undistributed post 31 December 2007 profits/reserves. It

can be assumed that the accounting reserves equal undistributed income for tax purposes (ie tax adjusted profits = accounting profits). The purchaser is effectively buying £50 of cash in the Guernsey company for £50. **However, care should be taken as there will be a further tax liability for the new shareholder on his proportion of the undistributed income remaining in the company and he might be advised to pay only £45 for his share.**

At the point of sale, the company is deemed to have made a distribution of 50% of its undistributed income (for tax purposes) - £50 - and tax will be due at 20% - £10. However, such payment is made on behalf of the vendor shareholder and should not be recognised as a tax charge in the profit & loss account of the company. The **suggested** accounting entries in the Guernsey company are as follows:

Dr Debtor - Original Deemed Distribution – tax of £10 due from the vendor shareholder

Cr Cash - Paid to Tax Office for the account of the vendor shareholder - £10

*Being the Guernsey tax paid on the deemed distribution of £50 being the vendor's share of the undistributed income @ 20%*

One way of dealing with the debtor account would be for the purchaser to withhold an element of the disposal proceeds payable to the vendor to credit against the debtor account. An alternative would be to leave the debtor balance until a subsequent dividend is paid, and then reduce the vendor's dividend payment by this amount. If the company subsequently pays an actual dividend in the sum of £100 (being the amount available for dividend in its accounting records), the entries would be:

Dr Dividend Profit & Loss Account £100

Cr Cash - Dividend to shareholders £80 (£45 paid to purchaser/£35 to vendor)

Cr Debtor - Original Deemed Distribution £10 (deducted from dividend paid to vendor)

Cr Cash - Paid to Tax Office £10 (in respect of tax on the remaining £50 of undistributed income for tax purposes - £5 credit to each shareholder)

*Being the accounting entries for the cash dividend of £100 which is declared by the Guernsey company and paid at a later date. This journal removes the original debtor for the tax paid on the deemed distribution on the sale of 50% of the Guernsey company by the vendor.*

The point to watch for partial share disposals is that tax will be payable by the company for the account of the vendor at the end of the quarter in which the sale occurs which will create a debt due by the vendor to the company. If this is not taken into account during the negotiation process (or otherwise dealt with through payment of a pre-sale dividend or adjuster clauses in sale and purchase agreements), it is possible that the purchaser may find himself out of pocket on the payment of a future dividend as in this case he has only received £45 for a £50 stake. Clearly there are many ways of looking at this, but vendors and purchasers must take it into account in the negotiation process.

### ***Exemption from the deemed distribution regime***

*It should be noted that a company is now able to exempt itself from the deemed distribution regime (in relation to trading profits) by making an election to distribute at least 65% of its profits within 12 months of the accounting year end. As such, and subject to certain anti-avoidance provisions, a subsequent disposal of shares in a company which has made such an election will not be a trigger event in relation to the remaining 35%.*

*The purchaser would also have an option after purchase to waive the election made previously under the original owner(s). However, regardless of whether the election is subsequently waived, the profits would still be subject to a tax charge if they are actually distributed.*

*Vendors and purchasers need to be aware of these factors and should take them into account during the negotiation process.*

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