TECHNICAL RELEASE

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COMPANY DISTRIBUTIONS: TRANSACTIONS IN SECURITIES REGIME AND LIQUIDATION DISTRIBUTIONS TARGETED ANTI-AVOIDANCE RULE

Note of meeting with HMRC on 26 January 2016 published by ICAEW Tax Faculty

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FOREWORD

On 9 December 2015 HM Revenue & Customs (HMRC) released a consultation document and draft legislation on company distributions, proposing amendments to the existing transactions in securities legislation as well as a new targeted anti-avoidance rule on liquidation distributions made by companies.

During the consultation period on 26 January 2016 HMRC hosted a meeting of its Capital Taxes Liaison Group at which ICAEW representatives were present. ICAEW's notes of this meeting have been passed to HMRC for review; the notes are reproduced below.

NOTE OF MEETING ON 26 JANUARY 2016

Re Company Distributions consultation document

Attendees:
Officials from HMRC
Representatives of the various professional bodies (including ICAEW Tax Faculty)

Consultation on proposed changes to transactions in securities (TIS) provisions and Targeted Anti-Avoidance Rule (TAAR) on liquidation distributions

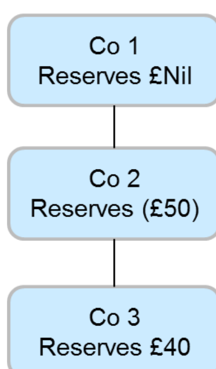
1. It was explained that the purpose of the proposed changes was to prevent avoidance involving turning amounts that would otherwise be taxable as income into sums taxable as capital, particularly given the increase to dividend tax rates from April 2016. A further purpose was to tidy up and clarify the TIS legislation.

Transactions in securities

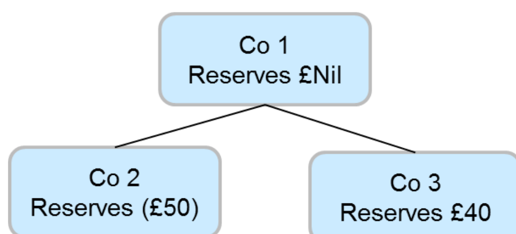
2. It was noted that, under the draft legislation, due to the attribution of interests of associates, it would be possible to tax the same reserves of the target company several times on different shareholders, leading to taxation of more than 100% of the company's total reserves under TIS. HMRC advised that they were aware of this issue, and that this was in fact already an issue under the existing legislation, although in practice they do not seek to tax more than 100% of the company's reserves under TIS. HMRC are exploring how to deal with this issue in the new legislation. It was noted that *Vestey v IRC* [1980] A.C. 1148 may provide judicial precedent that HMRC could not tax more than 100% of the reserves in any case.

3. HMRC advised that the introduction of s685(7A) ITA 2007 is to clarify not change the existing law, since they note that some people have taken a different interpretation to them. HMRC noted their view that the amount potentially taxable under TIS is the amount that could be paid as a dividend, even if a reduction of capital is associated with the actual payment.

4. HMRC provided a clarification of their view as to what reserves can be taken into account in counteractions under the draft legislation by way of two examples.



In this example, HMRC confirmed that no counteraction would be possible since no reserves could be made available for payment by way of dividend from Co 1 (a dividend from Co 3 to Co 2 would still leave Co 2 with negative reserves).



In this example, HMRC noted that they could effectively ignore the negative reserves of Co 2 and could issue a counteraction based on the £40 of reserves in Co 3, since these could be paid up to Co 1 and out to shareholders.

5. The issue of a reduction of capital was raised. In an example where, in order to support bank lending, the founding shareholders of a company had subscribed £5m as equity, and then several years later once the company's trading could support any debt, the shareholders wished to take out some of this £5m as a capital distribution by way of a capital reduction. Participants felt that this was perfectly reasonable and ought to be distinguished from "artificial" capital reductions such as set out in Example 2 of the consultation document published on 9 December 2015. Group members also noted that the initial investment will normally have come from taxed income, therefore it seemed particularly unfair, and unfriendly to UK businesses, that a return of these sums would be taxed as income again on extraction from the company. HMRC said they understood the issue and will take this back for discussion.

6. Group members queried whether, in example 2 in the consultation document, the share for share capital gains tax provisions would be disapplied in any case. HMRC noted that the example was a simple illustration for the document, but that it was based on a real scheme being sold to the public.

7. HMRC noted, in connection with the above, that if it were possible to identify capital that had never been utilised to generate profits (for example, monies subscribed to fund a project which never materialised) then this capital could be repaid to shareholders as capital and HMRC would not seek to counteract this.

8. Group members asked what the position was regarding amounts originally subscribed as debt and then subsequently capitalised. HMRC advised it would depend on what instrument was issued when the debt was capitalised.

9. HMRC confirmed that, in a situation where equity and debt were both being repaid, they would not normally look to counteract any debt repayment under TIS, since the expectation when debt is issued is that it will be repaid.

10. Group members queried whether a counteraction would be limited by cash availability to fund a dividend. For example, if all of the company's profits have been reinvested in plant and machinery, can there be a counteraction even though the company could not fund a dividend practically? HMRC advised they could counteract in this instance based on the reserves of the company.

11. Group members queried the interpretation of "indirect" holdings under the new fundamental change of ownership test in the draft legislation. HMRC noted that they simply take an arithmetic approach, multiplying percentage holdings down through any new companies inserted above the target company.

12. Group members queried the treatment of a disincorporation, whereby a trading company is liquidated and transfers all of its assets to the shareholders who then carry on the same trade, be it carried on by a former shareholder as a sole trader, by two or more former shareholders as partners in a partnership or as members of a limited liability partnership, under both the current and proposed new TIS rules. HMRC advised that under the current rules there is no TIS as there is no successor company and a simple liquidation is not a TIS. Under the proposed new rules the liquidation would be a TIS, but HMRC advised there would be no counteraction under TIS as long as it was a simple liquidation with no successor company or other ancillary issues. HMRC did note that the TAAR on liquidations would however need to be considered post 6 April 2016.

13. HMRC noted the difficulty with the clearance procedure in that they can only provide clearance where they are satisfied that the TIS legislation does not apply, but they would only counteract if they are confident that the legislation does apply, and there is clearly an area falling between these two situations, where the facts are not supportive of a clearance being given but would also not lead to a counteraction.

14. Regarding clearances HMRC advised that, following representations, they have been asked to comment on the proposed post 6 April 2016 rules in clearance applications. They are therefore adding a paragraph to all clearance letters saying either that their view is that the clearance will be void if the transaction happens after 5 April 2016, or that in their view the clearance will be unaffected by the new rules. HMRC's aim is for this wording to create a legitimate expectation for taxpayers to rely on and they will abide by their view expressed in these clearance responses.

15. Group members suggested that the taxpayer ought to be able to appeal the refusal to grant a clearance under TIS to the First Tier Tribunal, as a safeguard for taxpayers. In this regard, it was noted that the position for TIS clearances is in marked contrast to the equivalent capital gains tax and exempt distribution provisions, and that the consultation document specifically referred to additional taxpayer safeguards. It would therefore seem an obvious and beneficial change to make. HMRC agreed to take this back for discussion, and stressed that the clearance process is dependent on full and accurate disclosure by taxpayers.

TAAR on liquidation distributions

16. Group members asked whether "phoenixsm" was actually prevalent in practice, since they had not seen many examples. HMRC noted that there are a large number of taxpayers doing similar things, such as winding up their trading company and setting up a new one every couple of years. Group members questioned whether existing case law (*IRC v Joiner* [1975] STC 657) would deal with this issue, and HMRC responded that it would be clearer to have legislation dealing with this.

17. Group members noted that in certain industries, such as property development and private equity, it was normal market practice to use separate companies for each development/deal for entirely commercial reasons, such as to limit risk and satisfy banking requirements. HMRC recognised this and noted that they had already received consultation responses to this effect. HMRC noted that private equity commercial arrangements should not be targeted under the TAAR but appreciated that this was not clear from the consultation document. However HMRC did accept that property development could well be targeted under the TAAR as currently drafted.

18. Group members advised that it would be very helpful for clarification to be provided on this point. HMRC noted that this may be via HMRC guidance rather than in statute. Group members noted that clear and useful guidance would be critical and HMRC advised that this was a focus for them.

19. It was noted that there was a let out for reconstructions utilising s110 Insolvency Act 1986 as distributions of 51% subsidiaries were excluded from the ambit of the TAAR.

20. HMRC noted in relation to the "effective 51% subsidiaries" definition in the TAAR, one option being considered was to remove this definition and simply refer to "subsidiaries".

21. HMRC also advised that there is no clearance procedure for the proposed TAAR and the draft legislation does not introduce one. It was also noted that, whilst a liquidation distribution has been brought within the definition of a transaction in securities, a clearance under TIS does not mean that the TAAR will not apply. HMRC did note, however, that they would draw the attention of the applicant to the TAAR legislation when responding to a TIS clearance where its relevance was apparent, although failure to do so would not prevent the TAAR from potentially applying.

22. Group members asked whether the Non-Statutory Business Clearance (NSBC) service could be used for clearances under the TAAR. HMRC advised that this would be difficult as a NSBC would not normally be given on an anti-avoidance measure.

23. HMRC noted that consideration was being given to amending the exclusion from the TAAR for amounts of share capital originally subscribed to exclude amounts representing the capital

gains tax base cost of the shares, since this would prevent situations such as a liquidation following an inheritance being counteracted using the TAAR.

24. Group members queried the position of investment companies. For example, a family investment company is liquidated after the parents die, and the same "activity" (investing in shares and bonds for example) is undertaken by the children afterwards. HMRC advised that consideration is being given to restricting the TAAR to "a trade" rather than "a trade or activity" carried on after the liquidation, which would remove any issue here. It was also noted that this would protect landlords who wind up companies carrying on a rental business.

25. Group members asked whether the following examples would be caught by the new TAAR in HMRC's view:

i. an accountant retires and liquidates his company, then after six months of retirement he wants to fill some of his free time and decides to take on a couple of clients.
ii. the shareholders of a company wish to sell their business, but the third party purchaser insists on purchasing the trade and assets rather than the shares in the company. This sale goes ahead and then the shareholders liquidate the company and subsequently carry on a similar trade via a new company.
iii. an accountant retires from his own practice and liquidates the company, then goes to work full time for his brother's accountancy practice.

26. HMRC advised their view was that examples (i) and (ii) would not fall within the TAAR as they did not have a tax avoidance purpose.

27. HMRC noted that example (iii) was more difficult to test and the precise facts and motives of the taxpayer would need to be considered.

28. HMRC confirmed that, in terms of liquidations straddling 6 April 2016, it was the date of the distribution that determined whether the TAAR could apply, so a distribution pre 6 April 2016 could not be caught, but a distribution made after 6 April 2016 in the same liquidation process could be caught. Group members queried the fairness of this in respect of liquidations that had commenced before the consultation document was released on 9 December 2015 and suggested there ought to be grandfathering provisions protecting distributions from such liquidations. HMRC agreed to take this back for discussion.

29. Group members raised the issue of taxpayers evidencing their intentions where a motive test is included in legislation, for which the burden is generally on the taxpayer, and noted that it would be useful if one team within HMRC dealt with all TAAR counteractions so that there was consistency in approach. HMRC advised that this was likely to happen but had not been decided yet.

Wider solutions

30. HMRC advised that the "Potential wider solutions" section of the consultation document was purely to stimulate discussion and there are no current plans to introduce any measures other than the announced measures coming into force on 6 April.

31. The group members expressed a dim view of the complexity of close company apportionment and any thought of bringing this back. HMRC also noted that their resource would not allow for these rules to be brought back in a similar fashion to the old rules, a simpler version would be needed, but again stressed that there was no intention to consider doing this at present.

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32. Group members queried the complexity of the exempt distributions legislation relating to individuals, and suggested this could be simplified by referring to the definition of a scheme of reconstruction in Sch 5AA TCGA 1992, alongside an avoidance motive test, and then the rest of

this legislation could be disposed of. HMRC noted the difficulties with this legislation and asked that this be included in responses to the company distributions consultation document.

33. In relation to a purchase of own shares and Statement of Practice 2 (1982), group members asked whether HMRC ever in practice agree to selling shareholders retaining more than 5% of the company's shares. HMRC noted that this is fact specific, but that they have seen cases where the selling shareholder retains as much as 24% of the shares in the company but HMRC have still been satisfied that there is a clear benefit to the trade.

Postscript

34. *Following the meeting a further query was sent to HMRC by e-mail to clarify the transitional provisions in respect of the TAAR on liquidation distributions, in particular in respect of liquidations where distributions are made both before and on or after 6 April 2016, and where all distributions are made on or before 5 April 2016 but the liquidation process is not complete until on or after 6 April 2016.*

35. *HMRC's response was as follows, on the basis of the draft legislation:*

> *‘The legislation as drafted applies to “a distribution made to an individual in respect of share capital in the winding up of a…company”. The commencement provision says “the amendments made by this section have effect in relation to distributions made on or after 6 April 2016”.*
>
> *‘This means that where a winding up ends on or after 6 April, but all distributions were made on or before 5 April, the legislation will not apply. Where a winding up has some distributions on or before 5 April, and some on or after 6 April, the legislation will only apply to those distributions made on or after 6 April.’.*

APPENDIX 1

ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.

4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.

5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see icaew.com/en/technical/tax/tax-faculty/~/media/Files/Technical/Tax/Tax%20news/TaxGuides/TAXGUIDE-4-99-Towards-a-Better-tax-system.ashx)