MACFARLANES

INSIGHT AND ANALYSIS: THE CONDOC ON COMPANY DISTRIBUTIONS

THIS ARTICLE WAS FIRST PUBLISHED BY TAX JOURNAL
ON 8 JANUARY 2016

Q&A

The condoc on company distributions

Speed read

On 9 December 2015, HMRC published a consultation document entitled *Company distributions*, together with draft legislation to amend the transactions in securities rules in Chapter 1 of Part 13 of ITA 2007 and to introduce a targeted anti-avoidance rule (TAAR) to prevent certain distributions in a winding-up being treated as capital distributions. The consultation document requests comments on the proposed changes and canvasses views on whether wider reform may be desirable.

Ashley Greenbank
Macfarlanes
Ashley Greenbank is a partner in the tax group at Macfarlanes LLP. He advises on the full range of corporate tax issues, group tax planning and dispute resolution. He is a CEDR accredited mediator. Email: ashley.greenbank@macfarlanes.com; tel: 020 7849 2512.

What are the policy reasons for making the proposed changes now?

At the time of the Budget in March 2015, the chancellor announced some radical changes to the tax treatment of distributions for income taxpayers. They include the introduction of an annual allowance of £5,000 within which dividends will not be subject to tax; and new tax rates for dividends which do not fall within the allowance. The changes will take effect from 6 April 2016.

The effect of these changes will be to increase the tax charge on many higher and additional rate taxpayers who receive dividends from UK and non-UK companies. The increasing difference in the tax rate between receiving a return from a company as a dividend, which will be taxed at rates of up to 38.1%, and realising a capital gain, which will be taxed at rates of up to 28%, may provide an incentive for taxpayers to structure transactions to receive a capital rather than an income return.

What are the most likely problem areas?

The consultation document focuses on four potential problem areas:

- sales of companies with retained profits: where a shareholder sells shares in a company which has retained profits that could have been distributed to the shareholder by way of dividend;
- distributions in a winding-up: in particular, where distributable profits in excess of a company's needs are retained in a company, so that they can be returned in capital form in a subsequent liquidation (a practice it refers to as 'money-boxing'); or the use of 'phoenix' companies, where a company with distributable profits is liquidated but the owner continues the same business in a new entity;
- repayments of share capital and premium: although HMRC accepts that a repayment of an amount subscribed for shares should be treated as capital, it is concerned at the manipulation of the rules which determine the amount of capital that is treated as paid up on shares for tax purposes; and
- share buy-backs by unquoted companies within the special rules (in CTA 2010 s 1033 et seq.): HMRC is concerned that the rules can apply beyond their intended purpose. (The document contains some suggestions for tightening the conditions. I have not dealt with them further here.)

How does the draft legislation seek to address these risks?

The draft legislation covers two areas:

- changes to the transactions in securities rules for income tax purposes (ITA 2007 Part 13 Chapter 1); and
- the introduction of a TAAR in ITTOIA 2005.

However, it is quite limited in its ambitions. It focuses on particular avoidance risks that are created by the increase in the differential between the tax rates on returns from companies as income and capital. Moreover, it only applies to income taxpayers; and is limited to returns from close companies (or companies that would be close if they were UK resident).

What are the proposed changes to the transactions in securities rules?

The transactions in securities rules have been the customary defence against attempts to convert returns that might otherwise be dividend income into capital form. The rules are very broad in many respects. However, they have limitations, some of which the draft legislation seeks to address.

Definition of transactions in securities

The draft legislation will extend the types of transactions which can fall within the rules by including repayments of capital (including premium) paid up on shares, and distributions made in a winding-up within the definition of 'transaction in securities'.

The person in question

One limitation of the existing legislation is that it only applies where the person who secures the tax advantage is also a party to the transaction in securities. This has made the legislation largely ineffective, for example, in relation to some transactions involving offshore trusts where the trustees are party to the transaction but the tax advantage is the reduction in a liability of the settlor. That lacuna is addressed through the introduction of a connected parties rule, so that tax advantages that accrue to an associate of a person who is a party to a transaction in securities can also be counteracted.

Relevant consideration

For the existing legislation to apply, a party to the transaction in securities must receive 'relevant consideration'; in broad terms, this 'represents the value of assets available for distribution by the company'. The wording suggests that the rules can only apply to the distributable reserves of a close company which is referred to in the remainder of the conditions. The draft legislation will extend the concept of relevant consideration to include amounts which represent the value of assets available for distribution to the relevant company by way of dividend from any company which it controls. It is not clear whether that hypothetical dividend itself has to be capable of creating distributable profits in the hands of the relevant company.

Fundamental changes in ownership

The draft legislation also makes changes to the exception from the rules for transactions which involve a 'fundamental change of ownership'. The focus will now be on the interest retained by the original holder(s) (rather than on the interest acquired by others) and encompass indirect holdings. Therefore, there will be a fundamental change of ownership if the original holder(s) do not hold directly or indirectly 25% or more of the ordinary share capital, the rights to distributions or voting rights in the company after the transaction.

Timing and clearances

The new rules will apply to any transaction which takes place on or after 6 April 2016 or any series of transactions part of which takes place on or after that date. The existing clearance procedure is preserved. However, as drafted, any clearance for which an application is made before 6 April under the current rules will be void and cannot be relied upon in relation to a transaction which occurs (or a series of transactions a part of which occurs) on or after 6 April 2016 if it would be caught by the new rules (but not the old). No provision is made for an application to be made in advance for such transactions. It is to be hoped that some practical solution will be found.

How does the new TAAR operate?

The new TAAR is designed to address the use of phoenix companies. In broad terms, it will apply where: an individual receives a distribution in the winding-up of a close company; within two years, the individual or a connected person carries on a similar trade or activity as the company; and the main purpose (or one of the main purposes) of the arrangements was to avoid an income tax charge. Where the TAAR applies, the distribution is retrospectively taxed as dividend rather than a capital distribution.

The TAAR contains exceptions for distributions which either: represent a return of amounts originally subscribed; or comprise distributions of irredeemable shares in private companies which are effective 51% subsidiaries of the distributing company. The latter exception is designed to assist demergers, but is narrowly drawn. It will need to be recast if it is to extend to common structures for demergers, such as distributions under the Insolvency Act 1986 s 110, where a liquidator transfers shares in subsidiaries to new companies in exchange for shares which it distributes among the members of the liquidated company.

Are there any proposed changes to the rules which determine the level of capital paid up on shares?

No. The document suggests that legislation might be introduced 'to prevent the conversion of income to capital' by 'amending the parts of the existing distribution legislation that deal with income and capital'. But there are no firm proposals for any changes at this time.

The document includes an example of a case where a new holding company is inserted on top of a group by way of a share exchange. Under the existing rules (CTA 2010 s 1115), the shares in the new holding company are treated as paid up in an amount equal to the value of the shares in the original holding company that were transferred to it as part of the exchange. HMRC's concern is that this treatment potentially allows the value of the original company (including any distributable profits) to be returned to shareholders as a repayment of the capital on the shares in the new holding company.

The proposed legislation deals with some of the issues arising from this example by broadening the scope of the transaction in securities rules (as described above), but it does not address directly the increase in capital paid up on the shares in the new holding company. The problem with doing so is that these provisions are important in corporate reorganisations – whether to facilitate the mergers or clear dividend blocks – and broader legislation may have collateral damage without some material changes to other aspects of the tax regime.

How does the draft legislation deal with 'money-boxing'?

As I have described, the proposed legislation includes measures to tax the return of accumulated profits as income when they are distributed to shareholders in a winding-up. It does not address directly the benefit of deferring an income tax charge by accumulating profit within the company.

The consultation document does ask whether consideration should be given to the introduction of a rule under which the profits of close companies might be apportioned to their participators and taxed as income. Similar rules, of course, existed in the 1970s and 1980s. It might be argued that, with the differential between corporation tax and income tax rates set to increase further, perhaps it may be time to look at this type of measure again.

The document is at pains to point out that no decision has been taken. Let's hope that this consultation is as far as it gets. The theory may be good, the practice less so, particularly outside the context of investment holding companies. It presents a significant compliance burden for smaller companies, artificial distinctions are made between companies subject to apportionment and those which are not, and difficult distinctions are made between profits that are 'excess' and those which are required in the business.

Is the regime in need of wider reform?

The document goes on to ask whether a broader consultation on the distribution regime as a whole might be justified.

It is certainly true that the current regime might benefit from a more comprehensive review. It draws many of its key concepts from historic company law principles of maintenance of capital. The world has moved on. Many jurisdictions outside the UK base their company law distribution rules on solvency, rather than the maintenance of capital. Indeed, the UK's own regime has moved in this direction, particularly following the introduction of the rules permitting private companies to reduce their capital by means of a shareholder resolution supported by solvency declaration. The current regime also contains many anomalies – often derived from its piecemeal evolution – resulting in some provisions which arguably are no longer required or which address issues better dealt with elsewhere in the legislation.

So the real question is, if there is to be reform, what principles should replace the existing regime. The current regime does at least have the benefit of familiarity for most taxpayers. A new regime would inevitably create many winners and losers who will need to be convinced of its ultimate benefits. ■

The consultation document is available via www.bit.ly/1Y7Hst1. Comments are invited by 3 February 2016, 11:45pm. For details of other proposals currently open for consultation, see Tax Journal's consultation tracker at taxjournal.com (under the 'trackers' tab).