PHOENIX FRIGHTS

The Finance Act 2016 counters tax-driven phoenix practices but creates uncertainty for legitimate company liquidations, warns **Peter Rayney**

Owner managers generally expect liquidation distributions to fall within the capital gains tax (CGT) regime. The clear statutory rule in s1030, Corporation Tax Act 2010 (CTA 2010) stipulates that distributions received during the course of a winding-up do not count as income distributions.

Consequently, liquidation distributions would be taxed as capital distributions under s122, Taxation of Chargeable Gains Act 1992 (TCGA 1992). In many cases, assuming the relevant conditions in s169I (7) TCGA 1992 are satisfied, 'capital' liquidation distributions should benefit from the beneficial 10% CGT entrepreneurs' relief (ER) rate. If ER does not apply, a capital distribution is normally taxed at the main CGT rate of 20%.

This is all well and good where the winding-up is triggered by the owner-manager's retirement from business life, invariably following a sale of the trade and assets by 'their' company or a complete cessation of the business.

UNACCEPTABLE ARRANGEMENTS

In recent years, the beneficial CGT treatment of liquidation distributions has led to an increased use of tax-driven phoenix arrangements. Typically, this would involve the owner manager transferring the company's trade to a new company owned » 44

by them and/or their close family members. (There may, of course, be tax charges arising on the transfer of the assets to the new company.) The original company would then be wound up in the expectation that the distributions received from the liquidator would be taxed at the 10% ER CGT rate. Sometimes this process would be repeated more than once.

HMRC has always taken a dim view of this type of tax-engineered 'phoenixism'. In HMRC's view, these are contrived arrangements by shareholders to extract the company's distributable profits without paying (much higher) dividend income tax rates.

In 2016/17, the income tax rates for sizeable dividends are 32.5% (between £32,000 and £150,000) and 38.1% (above £150,000). On the other hand, if the same amounts were received as capital distributions with ER, they would be taxed at 10%.

Arguably, HMRC could always invoke the Transaction in Securities (TiS) legislation to deal with unacceptable forms of phoenix transactions. Thus, if HMRC believed that a winding-up had been motivated by the avoidance of income tax, it could make a counteraction assessment to tax the liquidation distributions at (dividend) income tax rates.

Given the potential risk of liquidations being caught by the TiS provisions, many prudent advisers often seek an advance s701 Income Tax Act 2007 clearance before implementing a legitimate winding-up. This enables them to proceed with the comfort that HMRC would not seek to tax the liquidation proceeds at 'dividend' income tax rates under the TiS regime.

5/4/16

The current targeted anti-avoidance rule (TAAR) applies to relevant capital distributions made after 5 April 2016

ESC C16 ABOLITION

In February 2012, HMRC took the opportunity to make life more difficult for those engaging in phoenixism when it abolished the long-standing extra-statutory concession – ESC C16.

Under the old ESC C16, shareholders could generally obtain 'capital' treatment for distributions made shortly before a (much simpler) striking-off procedure under the Companies Act 2006. ESC C16's statutory replacement, s1030A CTA 2010, is far more restrictive since it only permits 'capital' treatment for distributions totalling less than £25,000 made prior to a 'striking-off'. The £25,000 'cap' significantly limits the ability to make worthwhile tax savings by striking-off a company as part of a phoenix arrangement.

It seems that a number of phoenix arrangements were not being picked up by HMRC's fiscal radar. In most cases, this was probably down to a lack of proper disclosure on shareholders' tax returns or a failure to report such transactions altogether. HMRC clearly felt that it needed additional statutory weaponry to counter the growing use of 'unacceptable' phoenix practices.

ANTI-PHOENIX TAAR

HMRC unveiled its new statutory weapon in the form of section 35, Finance Act 2016, which plants a new section 396B within the Income Tax (Trading and Other Income) Act 2005 (ITTOIA 2005) – often known as the 'anti-phoenix' TAAR (targeted anti-avoidance rule). The TAAR applies to relevant 'capital distributions' made after 5 April 2016 and seeks to counter 'unacceptable' phoenix arrangements by taxing them at dividend income tax rates.

The potential scope of the TAAR is very wide. Section 396B, ITTOIA 2005 applies to UK resident companies – similar provisions apply to non-resident companies in s404A, ITTOIA 2005. The TAAR lays down four conditions, all of which must be satisfied to trigger the TAAR for the relevant shareholder. These are summarised below:

Condition A – immediately before the company is wound-up, the individual shareholder must have held at least a 5% equity (and voting) interest in the company;

Condition B – the distributing company must be a close company (or was a close company at some point within the two years before the winding-up);

Condition C – within two years from the receipt of the liquidation distribution, the recipient shareholder carries on, or is involved with, the same/similar trade or activity previously carried on by the distributing company.

The required 'involvement' of the shareholder can be through any business format and is widely defined in s396B (4), ITTOIA 2005 to include being in business:

- as a sole trader; or
- through a partnership/LLP in which they are a partner; or
- via a company in which they (or a 'connected person') have a 5% equity and voting interest.

Cases where a connected company carries on the same/similar business are also caught.

Condition D – having regard to all the circumstances, it is reasonable to assume that the main purpose or one of the main purposes of the liquidation or arrangements is the avoidance or reduction of income tax.

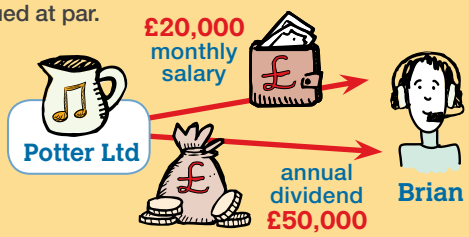
Where conditions A to D are met, the TAAR applies to 'capital distributions' made within » 46

CASE STUDY

APPLICATION OF ANTI-PHOENIX TAAR AND TIS RULES TO A PROPOSED LIQUIDATION

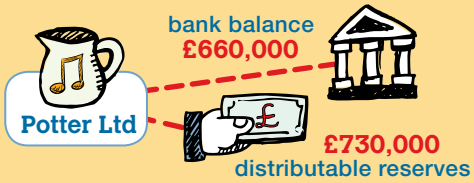
Brian has worked for over 20 years as a freelance radio presenter and DJ. For the past 15 or so years, he has run these activities through his 100% owned limited company, Potter Ltd. Brian has 100 £1 ordinary shares in Potter Ltd, which were issued at par.

Brian regularly draws a salary of around £20,000 and an annual dividend of £50,000 from Potter Ltd. He has no other income or major outgoings.



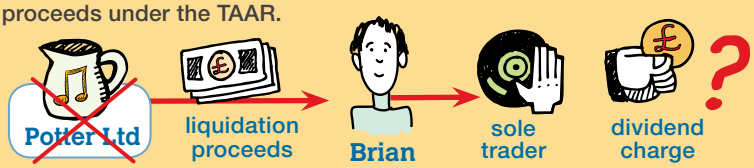
Brian is now approaching 66 and wishes to retire from his radio work by the end of 2016 and is contemplating winding up his company. However, he wants to continue with his 'private' DJ work at parties and weddings etc albeit on a scaled-down basis reducing to about two bookings per month.

Potter Ltd has a bank balance of about £660,000 and distributable reserves of around £730,000.

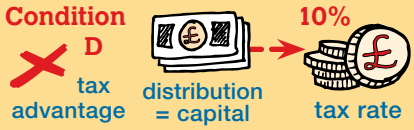


TAX ANALYSIS

Since Brian plans to carry on some DJ work as a sole trader (and this activity has previously been carried on by Potter Ltd), he might be vulnerable to an income tax dividend charge on his liquidation proceeds under the TAAR.

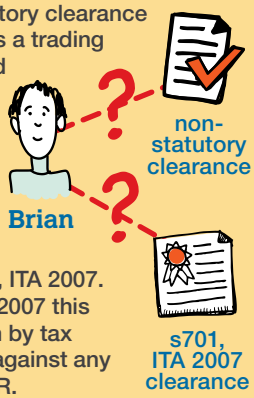


However, having regard to all the circumstances, it is reasonable to take the view that Brian has effectively retired from his mainstream work and that the liquidation of 'his' company is not mainly motivated by the avoidance or reduction of income tax. It is sensible for him to liquidate his company and to continue his DJ work on a relatively small scale as a sole trader. He would therefore have a robust case for reporting his capital distribution(s) received on the liquidation as capital gains, taxed at the ER CGT rate of 10%.



It might be prudent for Brian to seek a non-statutory clearance from HMRC to confirm that Potter Ltd qualifies as a trading company for ER purposes in the 12-month period before the trade ceases, notwithstanding the company's substantial cash balance.

Since distributions made in the course of a winding-up are within the scope of the TiS legislation, he might consider applying for an advance s701, ITA 2007 clearance to obtain comfort that HMRC would not seek to counter the liquidation distributions under s684 and s689, ITA 2007. Provided HMRC gave clearance under s701, ITA 2007 this would suggest that the liquidation was not driven by tax avoidance, which would strengthen his defence against any subsequent attempt by HMRC to invoke the TAAR.



EXAMPLES

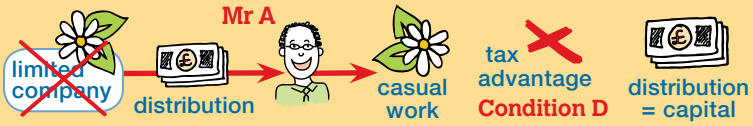
HMRC GUIDANCE EXAMPLES: USE OF TAAR

EXAMPLE 1

Mr A has been the sole shareholder of a company, which carries on the trade of landscape gardening, for ten years. Mr A decides to wind up the business and retire. Because he no longer needs a company he liquidates it and receives a distribution in a winding up. To subsidise his pension, Mr A continues to do a small amount of gardening in his local village.

Conditions A to C are met, because this is a similar trade or activity to landscape gardening. However, when viewed as a whole, these arrangements do not appear to have tax as a main purpose. It is natural for Mr A to have wound up his company because it is no longer needed once the trade has ceased.

Although Mr A continues to do some gardening, there is no reason why he would need a company for this, and it does not seem that he set the company up, wound it up, and then continued a trade all with a view to receiving the profits as capital rather than income. In these circumstances, Mr A's distribution will continue to be treated as capital.

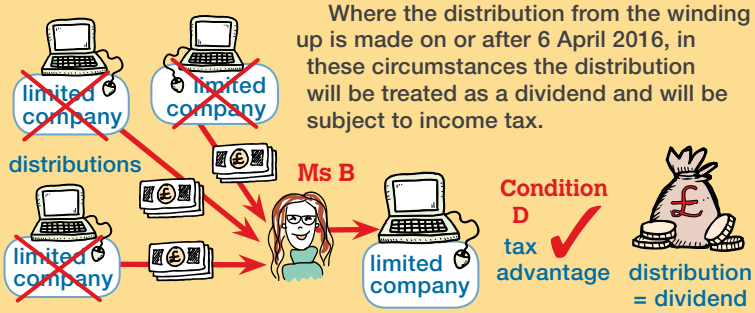


EXAMPLE 2

Ms B is an IT contractor. Whenever she receives a new contract, she sets up a limited company to carry out that contract. When the work is completed and the client has paid, Ms B winds up the company and receives the profits as capital.

Again, conditions A to C are met because Ms B has a new company which carries on the same or a similar trade to the previously wound up company. Here, though, it looks like there is a main purpose of obtaining a tax advantage. All of the contracts could have been operated through the same company, and apart from the tax savings, it would seem that would have been the most sensible option for Ms B.

Where the distribution from the winding up is made on or after 6 April 2016, in these circumstances the distribution will be treated as a dividend and will be subject to income tax.



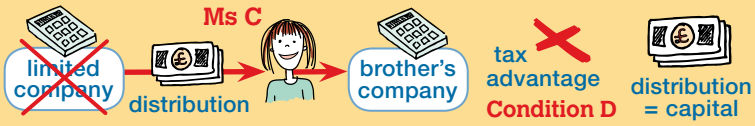
EXAMPLE 3

Ms C is an accountant who has operated through a limited company for three years. She decides that the risk involved with running her own business is not worth the effort and decides to accept a job at her brother's accountancy firm, which has been operating for eight years. Ms C winds up her company and begins life as an employee.

Conditions A to C are met because Ms C is continuing a similar activity to the trade that was carried on by the company. She is continuing it as an employee of a connected party, triggering Condition C.

But looking at the arrangements as a whole it is not reasonable to assume that they have tax advantage as a main purpose, so Condition D will not be met. Ms C's company was incorporated and wound up for commercial, not tax, reasons. Although she works for a connected party it is clear that the other business was not set up to facilitate a tax advantage because it has been operating for some time.

In these circumstances, the distribution from the winding up will continue to be treated as capital, absent any other considerations.



** Extracted from HMRC's standard response letter to requests for non-statutory clearances under the TAAR*

two years of the recipient shareholder carrying on the same/similar activity (as defined in Condition C). Therefore, in theory, it might be possible to side-step the 'income dividend' treatment if the shareholder is prepared to wait for more than two years before starting the same or a similar business activity through a company or partnership, etc. However, in offensive cases, HMRC could still make a counteraction under the TiS regime.

The practical application of Conditions C and D is particularly subjective. While they clearly catch 'tax-engineered' phoenix operations, they could also apply to a number of legitimate liquidations. Section 396B (6) stipulates that the circumstances in Condition D particularly include the fact that Condition C is met.

HMRC has stressed that while Condition C may be widely drawn, its intention is that Condition D narrows the application of the TAAR to circumstances where, when considered as a whole, the arrangements have a tax advantage as one of the main purposes. Thus, Condition D becomes the real 'crunch' test.

Section 396B (7), ITTOIA 2005 prevents the TAAR from applying where the liquidation dividend would not give rise to gain for CGT purposes. Thus, for example, shareholders would be protected from the TAAR if the capital distributions did not exceed their CGT base cost.

Similarly, in-specie distributions of irredeemable shares are not caught by the TAAR. This exemption should ensure that genuine company reconstruction operations under s110 Insolvency Act 1986 do not fall within the TAAR, although it is difficult to see them being driven by tax-avoidance in the first place.

There are concerns that HMRC could seek to apply the TAAR to the legitimate commercial use of separate 'special purpose' companies, which are frequently used by property developers, concert

promoters and those carrying on similar 'risk' businesses. Such companies are used to carry out a particular project or activity to ring-fence commercial risks and perhaps to allow for different investors. HMRC has indicated that the application of the TAAR here would depend on the precise circumstances of each case.

Tax advisers would argue that the use of special purpose companies is not mainly driven by the avoidance of income tax. However, given the subjective nature of the TAAR, there is now a degree of uncertainty. In response, we may now see special purpose companies being owned within a corporate group structure rather than as separately owned entities.

HMRC has provided several examples to illustrate how it sees the TAAR being applied in practice (see examples on p46). These examples are pretty clear-cut and probably do not cover the wide spectrum of cases that are likely to apply in practice. They emphasise the approach of looking at the totality of the arrangements to determine whether they were (mainly) driven by the avoidance or reduction of income tax. For a more complex case (based on a recent consultancy assignment) see case study on p45.

SELF-ASSESSING TAAR

Owner managers must determine whether they should self-assess their liquidation distributions under the TAAR. Given the complexity of the provisions, they are likely to rely on the guidance provided by their accountants and advisers.

It is unfortunate that HMRC does not provide any advance statutory clearance procedure to obtain confirmation that the TAAR will not be invoked. HMRC's position is that it does not give clearances on the application of a 'main purpose' motive test. It would appear that requests to seek a ruling from HMRC using the 'non-statutory' clearance rules have been unsuccessful. In recent months, applicants have received a standard HMRC notification giving the examples shown on p46 to provide some guidance.

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In this context, it is worth noting that the FA 2016 now provides that liquidation distributions firmly fall within the definition of a TiS. Consequently many advisers feel justified in seeking a s701, ITA 2007 clearance before implementing a winding-up.

If HMRC provides a satisfactory s701 clearance, this would imply that it accepts the transactions were not (mainly) motivated by the avoidance of income tax. Although a satisfactory s701,clearance does not cover the TAAR provisions, the fact that HMRC has agreed that a liquidation is not mainly motivated by the avoidance of income tax, should be a pretty persuasive defence in the event of HMRC subsequently seeking to apply the TAAR.

In conclusion, advisers generally support the introduction of the TAAR to deal with offensive phoenix practices. Unfortunately, genuine liquidations may get caught in the crossfire and the TAAR is likely to make the tax treatment uncertain in many cases. The practical answer, of course, would be for HMRC to introduce an advance statutory clearance procedure for the TAAR, but that is another story.

PETER RAYNEY FCA, CTA (FELLOW),TEP
runs a specialist independent tax consultancy practice, Peter Rayney Tax Consulting Ltd
www.peterrayney.co.uk