The duck test

KEVIN SLEVIN explains that the retention of cash does not always prejudice a company's trading status.

istockphoto.com

Possession of substantial "cash at bank" is often thought to be a major determining factor when considering the issue of a company's trading status for capital gains tax entrepreneurs' relief purposes and also for the corporation tax substantial shareholding exemption (SSE).

This article focuses on the writer's understanding of HMRC's current prevailing practice as regards the trading status of cash-rich companies (and groups too) and highlights the fact that the directors of most cash-rich trading companies will be successful in seeking confirmation, on behalf of their shareholders, from HMRC that they will regard the company as a trading company for these purposes. A company's commercial decision to retain profits rather than pay dividends to shareholders will seldom be a key issue in a company losing its trading status.

> ***"A decision to retain profits rather than pay dividends to shareholders will seldom be a key issue in a company losing its trading status."***

Setting the scene

Readers will be aware that a capital gain arising on the disposal of shares in company cannot attract entrepreneurs' relief unless the company is either a "trading company" or the "holding company of a trading group".

These terms are defined by TCGA 1992, s 165A(3) (see s 169S) as follows:

> "'Trading company' means a company carrying on trading activities whose activities do not include to a substantial extent activities other than trading activities."

Section 165A(4) and (5) proceed to give an extended meaning to the phrase "trading activities", but we need not consider this meaning here.

With regards to a trading group, s 165A(8) defines this as follows:

> "'Trading group' means a group of companies:
> (a) one or more of whose members carry on trading activities; and
> (b) the activities of whose members, taken together, do not include to a substantial extent activities other than trading activities."

Among other things, s 165A(9) to (14) inclusive give an extended meaning to the phrase "trading activities" and include special rules to embrace some joint venture situations and to further define matters such as "51% subsidiary". Again, we need not consider these matters here.

From the above it will be seen that the key issues to be addressed, whether in regard to a singleton company or a group of companies, are:

(a) what is meant by "substantial"; and
(b) having determined what is meant by substantial, how does one measure the various activities so as to collate the data required to form a judgment?

With reference to (a) above, it is well-known that HMRC's view is that the phrase substantial means, broadly speaking, more than 20% of the activities.

In relation to (b), the issue became one of defining which aspects of a company's activities must be examined in order to apply the so-called 20% test?

KEY POINTS

- The definitions of, and the official guidance on, trading status.
- Does the company look like a trading company?
- A trading company that retains its profits in cash will not normally be considered to have lost its trading status.
- The ability to obtain a pre-transaction clearance.
- Practitioners need to accept that there is uncertainty in the legislation.

Official guidance

The official guidance available to case workers and their superiors is to be found in HMRC's *Capital gains manual* at paragraph CG64090. Readers will already be familiar with this paragraph or will have ready online access to it and so it is not proposed to reproduce the full contents here. In short, it is a comprehensive summary which helps one understand how HMRC officers should approach any given situation. One of the opening paragraphs sets the scene as follows:

> "There is no simple formula to this but some, or all, of the following are among the measures or indicators that might be taken into account in reviewing a particular company's status. These indicators, adopted for entrepreneurs' relief, are the same as those used for the old taper relief and in the substantial shareholding exemption for corporation tax.
>
> - Income from non-trading activities.
> - The asset base of the company.
> - Expenses incurred, or time spent, by officers and employees of the company in undertaking its activities.
> - The company's history.
> - Balance of indicators."

As shown in ***CG64090 Indicators***, the manual proceeds to comment in detail on each of the above points.

Practical impact

Despite practitioners' concerns in the early days of entrepreneurs' relief and despite the memory of difficulties experienced by some advisers under the taper relief regime, what appears to be emerging is a helpful attitude by HMRC in interpreting the position in cases that can be said to be situated at the margins.

Although it may be an oversimplification to say that HMRC generally look to establish reasons to accept a company's trading status (or that of a group), practitioners should be happy that HMRC do not see their role in this area as one where they hide behind the rock of uncertainty in order to leap out and reject entrepreneurs' relief claims by challenging the trading status of a company whose financial success has been derived from trading activities. Rather, it seems that HMRC officials appear to accept that it was the intention of parliament to grant an important capital gains tax relief to entrepreneurs.

While HMRC have a duty to monitor claims and look out for entities "dressed up" as trading companies, and challenge them as necessary, the department does not have as its goal the exclusion of as many companies as possible from those that can be regarded as trading companies. Of course, there will always be difficult cases where the answer to the trading status question may not be immediately apparent, but just because, say, the entrepreneur running his successful family business has seen fit to retain substantial profits, it should not be assumed there will be a problem unless the accumulated funds have been put to use in what can be properly be described as a separate investment business activity.

CG64090 INDICATORS

HMRC's *Capital gains manual* lists indicators of trading status.

Income from non-trading activities
For example, a company may have a trade but also let an investment property. If the company's receipts from the letting are substantial in comparison to its combined trading and letting receipts then, on this measure in isolation, the company would probably not be a trading company.

The asset base of the company
If the value of a company's non-trading assets is substantial in comparison with its total assets then again, on this measure, this could point towards it not being a trading company. If a company retains an asset it previously used, but no longer uses, for the purposes of its trade, this may not be a trading activity (but see above regarding surplus trading premises). In some cases it might be appropriate to take account of intangible assets (eg goodwill) that are not shown on a balance sheet in considering a company's assets. Current market value and amounts given by way of consideration for assets may both be appropriate measures of the relative extents of a company's trading and other activities. Which measure is appropriate will depend on the facts in each case.

Expenses incurred, or time spent, by officers and employees of the company in undertaking its activities
For example, if a substantial proportion of the expenses of a company were to be incurred on non-trading activities then, on this measure, the company would not be a trading company. Or a company may devote a substantial amount of its staff resources, by time or costs incurred, to non-trading activities.

The company's history
For example, at a particular instant certain receipts may be substantial compared to total receipts but, if looked at on a longer timescale, for instance if a company's trade was seasonal, they may not be substantial compared to other receipts over that longer period. Looked at in this context, therefore, a company might be able to show that it was a trading company over a period, even where that period may have included particular points in time when non-trade receipts amounted to a substantial proportion of total receipts.

Balance of indicators
The indicators discussed should *not* be regarded as individual tests to which a 20% "limit" applies. They are factors, or indicators, that may be useful in establishing whether there is substantial overall non-trading activity. It may be that some indicators point in one direction and others the opposite way. You should weigh up the relevance of each in the context of the individual case and judge the matter "in the round" (see the approach of the Special Commissioner in the inheritance tax case of *Farmer and another (exors of Farmer dec'd) v CIR* SpC 216). If you are unable to agree the status of a particular company for a period then the issue could be established only as a question of fact before the First-tier Tribunal.

The duck test

It must be accepted that it is nearly impossible for HMRC to capture their approach in a single sentence or a single paragraph. However, the author understands that, broadly, the approach will be to apply a version of the "duck test".

It is often said that, if something looks like a duck, walks like a duck and quacks like a duck, the balance of probability is that the thing before you is a duck. Paraphrasing, if the company looks like a trading company, feels like a trading company and there is no compelling reason why it should not be treated as a trading company, the fact that it has a cash pile as part of its reserves will not be an impediment to successfully establish its trading status.

> ***"If the company looks like a trading company, the fact that it has a cash pile as part of its reserves will not be an impediment."***

Yes, there is a series of indicators to which HMRC case officers are pointed, but officers are advised that the commentary in HMRC's manuals covering this issue is not a set of boxes to be ticked so as to arrive at a clear result. Rather, the indicators recognise that, in any given situation, added weight might need to be given to certain factors as opposed to other less relevant factors and that "cash is not king" when it comes to reaching a balanced decision on the trading status issue.

Exceptions to the rule

Having set out our "duck test", there will of course be exceptions. In some situations, a distinction may be made between companies that have retained moneys on deposit or money market accounts and those which have placed their funds with a stockbroker for long-term investment. That said, the instructions given to a stockbroker may reinforce the argument that this company regards itself as making short-term investments in comparatively liquid form rather than carrying out activities which can be described as an investment business. Practitioners should ask to see the terms of engagement with a stockbroker or other financial adviser. An actively-managed portfolio held for a substantial period of time may well create more problems than would a situation where funds are simply invested largely as part of a capital protection strategy.

There will be what some might view as exceptions to the general approach. For example, if the company is in the habit of retaining money in order to make loans, the cash accumulation may be viewed as more of a business activity where interest is charged on such loans.

In many cases, HMRC are likely to regard the key issue – ranking above all others, but not to the exclusion of the other pointers – as being the time devoted to the different activities by both the workforce and by the board of directors of the company. In a situation where the company looks like a trading company, feels like a trading company and there is no compelling reason why it should not be treated as a trading company, the fact the directors decide each month to invest the company's reserves comprising retained profits from earlier years – and they spend an hour doing so – is unlikely to result in the company being regarded as not satisfying the trading company test.

Unsatisfactory law?

Some may take the view that this state of affairs, where one relies on HMRC officials taking a pragmatic approach to the situation – including having due regard to what parliament's intention was in introducing the legislation, is far from satisfactory. Although this may be a tenable view, in the author's view it is difficult to think of a way to structure the legislation to achieve the desired aim along with total certainty. Imagine how many schemes would appear, almost overnight, designed to allow investment companies to morph into so-called trading companies if the meaning of trading company definition was more tightly prescribed.

Readers should also not lose sight of the fact that they can approach HMRC in advance of a disposal of shares in a cash-rich company, explain the full facts and seek a clearance under the non-statutory business clearance procedure. If the full facts are clearly set out in an application to HMRC, it is likely that a positive pre-transaction ruling, where the taxpayer (or his agent) specifically raises the trading status issue as the area of doubt or uncertainty on which a ruling is sought, will be regarded as binding on HMRC. Readers are referred to the *Non-statutory business clearance guidance* at NBCG1200 et seq for guidance on the department's non-statutory approach to requests for clearances from business customers for confirmation of HMRC's view of the application of tax law to a specific transaction or event. Currently, the manual is silent on the definition of which business customers are entitled to request guidance. However, it is understood that HMRC will allow any individual shareholder to seek guidance regarding the trading status of the company in which he has invested and where there is an issue regarding entrepreneurs' relief.

Conclusion

As stated above, it is the author's understanding that the shareholders in a company should expect it to be treated as a trading company where if it looks like a trading company, feels like a trading company, and there is no compelling reason why it should not be treated as a trading company. It is also understood that the number of disputes with HMRC officials concerning the trading status of companies is believed to be small indeed. However, if readers do have any experience of the trading status of a company being surprisingly challenged, the editor will be pleased receive details.

Kevin Slevin CTA (Fellow) is an independent tax consultant advising professional practices. He is the author of *Entrepreneurs' Relief: A Guide for Practitioners* and can be contacted by telephone on 01608 811411 or email: Kevin@slevinassociates.co.uk