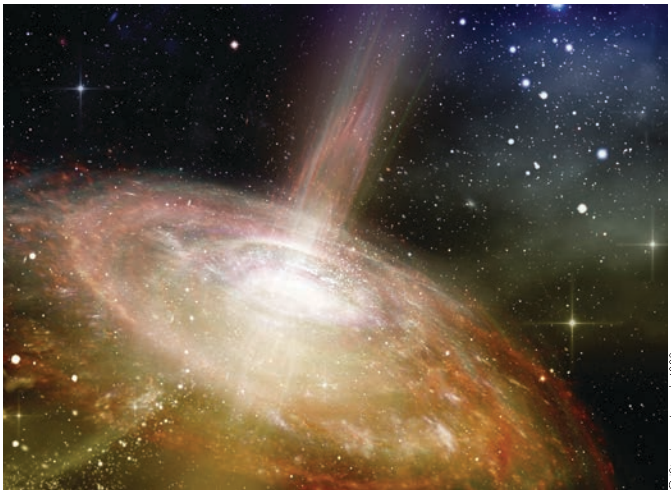
Into the great unknown

KEVIN SLEVIN discusses the known unknowns and other implications of ITTOIA 2005, s 396B in the context of members' voluntary liquidations.



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Readers will know that little to do with UK tax is as straightforward as it first appears. Alas, matters have not been made easier by the drafting of some aspects of the targeted anti-avoidance rule (TAAR) introduced by FA 2016 and now in ITTOIA 2005, s 396B. This is an important provision that could have far-reaching implications for some shareholders of close companies in the event of a members' voluntary liquidation (MVL) taking place.

This article is written for readers on a 'need to know basis'. By this I mean you need to know that I and many others, do not really know what we need to know to be able to advise you (with any certainty) what you need to know when seeking to apply this new legislation at the coal face. There are several 'known unknowns' lurking in s 396B. But HMRC has provided little in the way of meaningful guidance. This is a cause of concern given that any income tax liability arising under the section must be self-assessed by the taxpayer.

KEY POINTS

- The targeted anti-avoidance rule in ITTOIA 2005, s 396B has far-reaching consequences if a members' voluntary liquidation takes place.
- The aim of the legislation is to counter 'phoenixism' – starting a new business soon after winding up a previous one.
- Taxpayers are expected to self-assess if the new targeted anti-avoidance rule will result in a liability under s 396B.
- Condition C (see s 396B(4)) is met where, at any time within the period of two years beginning with the date on which the liquidation distribution in question is made, any one of the four Condition C 'trigger events' occurs. These are that:
  - The condition does not only apply when a new business is started after liquidation or distribution; other pre-existing businesses may trigger a liability.
  - Shareholders of the same business may have different tax charges.

The legislative purpose

For the avoidance of doubt, nothing in this article is intended to criticise the policy behind the measure in question. It was correct that the Treasury should ask HMRC to counter the practice often known as 'phoenixism'. This was especially the case because HMRC officials seemed reluctant, presumably due to the lack of resources, to apply the existing counteraction legislation which had the scope to reign in some of the excesses that were taking place. Well-intended legislation it may be, but I find difficulty in agreeing with HMRC that the wording of s 396B is 'clear'. That said, I am sure the Treasury can already claim with confidence that it is 'mission accomplished' as regards achieving the stated object of curtailing phoenix operations. There can be little doubt the mere existence of this measure has forced some insolvency practitioners to revise their business models to reflect the fall-off in MVL activity.

My grounds for concern stem from the fact that taxpayers are expected to self-assess this new targeted anti-avoidance rule to account for any liability arising under s 396B. Like HMRC, I also anticipate that in most cases the position whether the section is in point will be clear cut, but it has already been recognised by many tax professionals that the legislation reaches far beyond what practitioners recognise as being a so-called phoenix type of manoeuvre. The legislation may ensnare unsuspecting businessmen and women. Individuals doing no more than going about their everyday business activities in a manner that they hope will be tax-efficient could find themselves exposed to a liability.

Like it or not, practitioners whose personal tax clients are in receipt of a liquidation distribution during an MVL must ask searching questions before concluding whether the sum will be taxed as capital or dividend income.

The nitty gritty

Much has been written about s 396B in the professional press and I will be brief here. Broadly speaking, if it can be shown that four conditions are met, the amount by which any liquidation distributions made to a shareholder exceeds their allowable cost of the shareholding in question for capital gains tax purposes, must be treated as if it were dividend income arising on the date of payment and liable to income tax. This will be so despite the legal standing of such capital payments under company law.

Conditions A and B, which define the target companies and target shareholders, are no more than the building blocks of the measure. These conditions are clear and present no problems that I can see.

Condition A requires that, immediately before the winding up starts, the taxpayer must possess at least a '5% interest in the company'. This is deemed to be the case if they have at least 5% of the ordinary share capital of the company and can exercise at least 5% of the voting rights.

Condition B requires that the company be shown to be either a close company when the liquidator is appointed – in other words, at the start of its winding-up – or that it was a close company at any time in the two years ending with the start of the winding-up.

For the purposes of Condition A, if shares are held jointly in a close company each beneficial owner of the holding is to be treated as sole holder of so many of the shares as is proportionate to the value of their beneficial interest (and the entitlement to exercise the voting rights attributable to the joint holding is similarly apportioned).

It may be worth noting at this juncture that there is nothing in s 396B that limits its impact to the shareholders of trading companies. The liquidation of companies holding investments will be subject to the same scrutiny as trading companies.

The key provisions

The first of the two key provisions is Condition C.

If HMRC cannot show that this condition is satisfied there cannot be an income tax liability under s 396B. As we will see, it will take a bold person to say with certainty that they understand how this part of the legislation should be interpreted. Key matters are left open to interpretation. However, if Condition C is satisfied, Condition D – which broadly speaking is a motive test – must then be examined to establish whether it too is satisfied. A separate article will focus largely on Condition D, but will also allude to some of the associated transaction in security issues (ITA 2007, s 682 et seq) that also need to be addressed.

Condition C: the trigger events

Condition C (see s 396B(4)) is met if, at any time within the period of two years beginning with the date on which the liquidation distribution being made, any one of the four Condition C 'trigger events' occurs. These are that:

(1) the individual (in other words, the shareholder receiving the liquidation distribution) carries on a trade or activity which is the same as, or similar to, that previously carried on by the company in liquidation (or by an effective 51% subsidiary of the company – as defined in subsection 8); or

(2) the individual is a partner in a partnership which carries on such a trade or activity; or

(3) the individual or a person connected with them is a participator in a company in which they have at least a 5% interest and which at that time in the two-year period under review:
   (i) carries on such a trade or activity; or
   (ii) is connected with a company that carries on such a trade or activity; or

(4) the individual is involved with the carrying on of such a trade or activity that is conducted by a person connected with the individual.

Connected person is defined in ITA 2007, s 993 (see ITTOIA 2005, s 878). It includes the usual suspects.

The first point to emphasise on Condition C is that if none of the trigger events occurs within the two-year period, Condition C will not be satisfied and HMRC will not need to consider s 396B further. That said, it should be noted that the situation of each shareholder (possessing at least a 5% interest) in the liquidated company must be considered in light of their own circumstances, as illustrated by ***Mr A and Mr B***.

MR A AND MR B

Mr A and Mr B each receive £1m from the liquidator of their company on 1 July 2017, the company having ceased to trade in May 2017. Mr A and Mr B had run the company for ten years and had built up substantial reserves. After taking a three-month break, Mr A resumes some of the former company's trading activities. He approaches some of his old customer contacts and soon establishes himself as a sole trader. Mr A had long wanted to work away from Mr B and was delighted when Mr B announced that he wished to retire early and wind up the company. Indeed, Mr A had emailed some of his old customers when the old company ceased trading explaining that he was taking a three-month sabbatical and would soon be back knocking on their doors to see whether they needed his services again.

In these circumstances, Mr A may be due to self-assess an income tax liability under s 396B for 2017-18 (with the top rate being 38.1%) whereas Mr B will be liable to pay capital gains tax only. No doubt Mr B hopes to successfully claim entrepreneurs' relief to restrict his tax rate to 10% in respect of the liquidation distribution.

Note that in my reference to Mr A I have deliberately used the word 'may' when referring to the potential application of s 396B. Only HMRC claims to understand Condition D and so it may be possible to demonstrate that Condition D is not satisfied so that neither Mr A nor Mr B will ultimately face an income tax charge.

Tax return entries

It is important to note that any s 396B liability will fall to be self-assessed for the tax year in which the liquidation distribution

KAREN

Karen receives her liquidation distribution on 28 February 2018 in respect of KK Ltd a close company that ceased to trade on 30 November 2017. Although she is not certain as to her future business activity, Karen lodges her 2017-18 return and pays capital gains tax at the 10% entrepreneurs' relief rate on her gain of £500,000. This tax is paid on 31 January 2019.

On 1 January 2020, Karen starts a new business in partnership with her husband. The business is very similar to that formerly conducted by KK Ltd. Karen has overlooked the fact that the two-year window found in Condition C begins with the date of each liquidation distribution she received. Accordingly, Karen must consider whether she should file a correction notice for her 2017-18 her tax return because HMRC officials are likely to argue that Condition D is satisfied.

After taking advice, Karen formally notifies HMRC on 1 July 2020 – the same day she pays the additional tax.

Here, Karen will be expected to pay interest on the additional tax calculated to run from 31 January 2019.

The question of her possible exposure to a penalty will also need to be addressed.

HENRY AND JANE

Henry and his wife Jane are successful restaurateurs, who run three establishments through three separate associated companies. They close the business conducted by Company 1 because the lease of its trading premises has ended. Despite the financial consequences of last year's unfortunate incident with the rat poison and the red squirrel, Company 1 still retains substantial reserves and an MVL takes place. The first distribution of £1m is made by the liquidator to Henry and Jane as the sole shareholders on 1 December 2017. At this point, they are actively running the two continuing businesses through Company 2 and Company 3.

Even though there is no phoenix operation, Condition C is clearly satisfied at 1 December 2017 by both shareholders. Accordingly, they will escape a charge to income tax under s 396B on their respective liquidation distributions only if the purpose test Condition D is shown *not* to be satisfied.

is made. Therefore, the second point to note in relation to Condition C is that it will be a question of fact as to whether one of the four triggers has occurred at the point of lodging the individual's tax return.

A mere intention on the part of a shareholder to start a trade or activity similar to that previously carried on by the company and if even being in a state of planning to do so less than two years after the date of the liquidation distribution will *not* be trigger event within Condition C. Should the intended activity be abandoned or not start until after the second anniversary of the liquidation distribution, s 396B cannot apply and so the liquidation distribution will remain to be regarded as disposal proceeds for capital gains tax purposes. That said, if, at the time of lodging a taxpayer's return, plans for the new activity are well advanced so that a trigger event within the two-year window is imminent, it may make sense to provisionally self-assess the potential income tax liability under s 396B and declare the provisional figure (explaning in the white space provided or in a supporting document) and continue to monitor the position. There is, however, no obligation on the shareholder to do so and mistakenly assessing an income tax liability because it fails to arise is seldom a good strategy.

The example of ***Karen*** demonstrates the position.

Of course, if more than one liquidation distribution is made by the liquidator, each one will have to be tested separately under s 396B by focusing on the relevant two-year window relating to it.

Condition C: a change of heart?

We will now consider the position where, at the start of the MVL, there is no intention on the part of any shareholder in the company in question to carry on any post-liquidation business activities – let alone business activities similar to that carried on by the liquidated company. However, after a year spent relaxing one or more shareholders decides that early retirement is not for them. What is more, they decide that they only know one type of business activity and so they form a new company to carry on exactly the same trade conducted by their former company.

Let's say that the liquidated company (X Ltd) was a publisher of hard copies of works of fiction and the new business (Y LLP) does likewise except that it only publishes online ebooks. Let's also assume that this new business does not go well and they fold up with each member of Y LLP having made losses of £50,000.

In this situation, does their change of heart mean that each shareholder who benefited under the MVL must re-visit their personal tax return to self-assess their income tax liability under s 396B? The only answer there can be is that it all depends on whether Condition D is in point (something to be explored in a future article). The change of heart will not affect whether Condition C is satisfied – it clearly would be because it contains no purpose test. It is only Condition D that includes such a test.

Far-reaching legislation?

It will be noted that, for Condition C to be satisfied, the legislation does not require the 'same or similar trade or activity' to be started *after* the liquidation distribution has taken place or *after* the liquidated company has ceased its business – in other words, the type of linkage one might expect to see if the legislation was intended solely to counter phoenixism. Other long-established businesses can present a problem, as illustrated by ***Henry and Jane***.

The example of ***Henry and Jane*** will be discussed further in a later article.

Further issues arise on Condition C in the example of ***Fred and Jim***.

In ***Fred and Jim***, is it fair that Fred should be treated this way simply because he is adhering to the terms of his shareholders' agreement with Jim, which was entered into before 6 April 2016? Alas, the scope of the TAAR legislation is such that such niceties are not automatically taken into account when considering Condition C. Instead it will be necessary for Fred to

FRED AND JIM

Fred is an established property developer and owns 60% of X Ltd, a company with an issued share capital of £1,000 and for which an MVL is under way. X Ltd is cash-rich because four months ago it completed the sale of its single development project (which was sold to a third party) and discharged all its liabilities, including corporation tax.

The activities of X Ltd were financed in part by Jim, who owns the remaining 40% of the share capital. Like Fred, Jim subscribed for the shares at the par value of £1 each but he also made a director's loan of £5m to finance the development. Under a shareholders' agreement (entered into in 2011 when Jim invested in the company), it was agreed that X Ltd would be liquidated as soon as possible after the completed development was sold. Once all contractual commitments – including local authority works restoring pavements, drainage and such like – were carried out and approved, the company could be wound up to distribute the anticipated profit between the shareholders – not to mention permanently burying any unforeseen skeletons that might otherwise surface later.

The repayment of Jim's loan took place just before the liquidator was appointed leaving slightly more than £8m available for distribution between the shareholders. Accordingly, the liquidator distributed £4,800,000 to Fred on 1 November 2017 with a payment of £3,200,000 made to Jim on the same day.

Fred has a controlling interest in two other property development companies and their activities continued well beyond 1 November 2017.

Here, it seems that HMRC could say that Condition C is satisfied in relation to Fred because his two other property development companies each carry on a trade that is the same as, or similar to, that previously carried on by Company X Ltd.

Therefore, if HMRC can also show that Condition D is satisfied, the liquidation distribution made to Fred on 1 November 2017 will be regarded as dividend income for income tax purposes.

Jim will remain liable to capital gains tax because he has no other connection with property development (or with similar activities) and his wife has told him that he is never to get involved in such goings-on again. Jim will not breach the two-year rule unless he is willing to risk yet another divorce.

demonstrate that Condition D is *not* satisfied if he is to avoid an income tax liability. This is Fred's only defence.

The same as, or similar to, what exactly?

As already stated above, Condition C refers to the carrying on of a trade or activity which is the same as, or similar to, that previously carried on by the company in liquidation. The legislation makes no reference to the time at which it was carried on by the company. This is deliberate because there is no good reason why the post-MVL resumption of a trade that has ceased well before a company went into liquidation should not fall within s 396B – or at least that is how HMRC may see things. Therefore, if any activity is to be carried on by a former shareholder of a company that has been subject to an MVL (within the two-year window described above), careful attention should be given as to whether HMRC could successfully contend that Condition D is also satisfied. The outcome in these circumstances will always be determined by a close examination of the facts – taking into account the uncertainties arising in Condition D.

MARY AND JOHN

Mary and John have run ZYX (Hotel) Ltd for 30 years but, due to failing health, they decide to dispose of the business. Their first thoughts are simply to sell the shares in the company, but their buyer insists on purchasing the hotel business (including the property owned by the company) as a going concern.

After receiving the sale proceeds and payment of all corporation tax due, ZYX (Hotel) Ltd is the subject of an MVL and Mary and John each receive an initial distribution of £2m from the liquidator. They claim entrepreneurs' relief and expect to pay capital gains tax at 10%.

Mary and John seek advice about investing the net of tax monies. By chance they see an opportunity to buy a small hotel that is already let to a tenant who is trading successfully. The hotel has a good reputation and they have known the tenant for several years. After appropriate due diligence, they buy the hotel and start to receive rent from the tenant. This takes place less than six months after their first liquidation distributions are received.

HMRC can argue that the former shareholders are carrying on an activity which is similar to that previously carried on by ZYX (Hotel) Ltd and they are doing so within the two-year window. They will have to convince HMRC officials that Condition D is not satisfied.

“The outcome will be determined by a close examination of the facts.”

A further point which must be borne in mind for Condition C arises from the fact that the draughtsman deliberately refers to a trade or activity being carried on (in the two-year window) which is the same or similar to that carried on by the company. I interpret this to mean that a post-liquidation activity carried on as an investment activity can be compared to a pre-liquidation trading activity. Unfortunate though it may be, the example of ***Mary and John*** reflects a position that potentially falls within the legislation and that may cause surprise.

As mentioned above, a future article will focus on the second key issue, namely the interpretation of Condition D.

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