Is this a wind-up?

KEVIN SLEVIN looks at the implications of the new draft legislation on distributions in close company liquidations.


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Practitioners have now had a chance to recover from their valiant efforts in recent months helping clients to meet the 31 January deadline.

Now it is time to move on urgently to consider whether clients running their businesses through companies need to consider disincorporation.

The urgency is caused by proposed new legislation. Draft clause 18 to the Finance Bill 2016, published by HMRC on 9 December 2015, introduces what will be a new ITTOIA 2005, s 396B headed 'Distributions in a winding up'. This clause introduces a measure designed so that, if certain conditions are met, distributions received by a shareholder from the winding-up of a company (and made post-5 April 2016) will be treated as if they are dividends chargeable to income tax in the shareholder's hands and therefore are chargeable under the new regime for dividends starting in 2016/17.

It is worth recalling here that the rates of income tax for dividends received above the £5,000 allowance on or after 6 April 2016 will be:

- 7.5% for dividend income within the basic rate band;
- 32.5% within the higher rate band; and
- 38.1% within the additional rate band.

KEY POINTS

- A draft clause 18 in Finance Bill 2016 will introduce a new ITTOIA 2005, s 396B on distributions to shareholders in a winding-up.
- For a close company being wound up for the avoidance or reduction of income tax, after 5 April 2016 distributions received by a shareholder will be treated as dividends chargeable to income tax.
- A family business wishing to remove their activities from a close company structure needs to consider whether to time any distributions pre- or post-6 April 2016.
- Changes to the transactions in securities (TIS) provisions take effect from 6 April 2016 but the existing provisions continue for the remainder of this tax year.
- HMRC has indicated that where a business is succeeded by a shareholder(s) who then trades as a sole trader or partnership, current TIS provisions are unlikely to apply.

Readers will appreciate that it will not be unusual for the 38.1% rate of tax to apply if the company has accumulated significant reserves.

It should also be noted that, to the extent the £5,000 dividend allowance (which applies to dividends from both resident and non-resident companies for UK tax purposes) is used by a taxpayer, his nil rate band will be correspondingly reduced.

The upshot of clause 18 will be that, although a distribution made in a members' voluntary liquidation on or before 5 April 2016 for a trading company will, broadly speaking, give rise to a capital gain which is taxable at either 28% or 10% – depending on whether the shareholder is entitled to entrepreneurs' relief – the maximum tax rate applicable on a distribution made on or after 6 April 2016 will, again broadly speaking, rise to 38.1%. In other words, where the new legislation bites, the maximum tax payable on a liquidation distribution in 2016/17 may be nearly four times that payable on the same payment received by a shareholder in 2015/16.

The conditions

The dividend treatment in s 396B will apply only when a distribution is made in respect of shares and HMRC can demonstrate that three conditions (A to C) are met.

Condition A is that the company being wound up must be a close company (as defined by CTA 2010, s 439) or can be shown to have been a close company at some point in the two years prior to the winding up.

Condition B is that the person who receives the distribution is involved with the carrying on of a trade or activity that is similar to that carried on by the company being wound up. For this purpose the shareholder will be considered to carry out the trade where he or she does so directly, through a company he or she controls, or through a person with whom he or she is connected.

Condition C is that it is reasonable to assume, having due regard to all the circumstances (and in particular the fact that condition B is met) that:

(a) the main purpose or one of the main purposes of the winding up is the avoidance or reduction of a charge to income tax, or
(b) the winding-up forms part of arrangements, the main purpose or one of the main purposes of which is the avoidance or reduction of a charge to income tax.

For condition C it is best assumed at this stage that HMRC will argue that, if a pre-liquidation dividend could have been paid to shareholders but was not so paid, the decision not to pay a dividend was part of an arrangement made with the company by its shareholders the main purpose of which was to avoid income tax.

It is worth mentioning at this point that the draft legislation provides an exemption if it can be shown the distribution received by the shareholder is either a repayment of share capital originally subscribed, or if it comprises only shares in a subsidiary of the wound-up company. This would be the case in a liquidation de-merger.

Carry on trading

The introduction of the 7.5% 'dividend surcharge' from 6 April 2016 has already led many family businesses to question whether they should continue to carry on their businesses through the medium of a company. The pros and cons as regards this decision-making process are outwith the scope of this article, but it will be seen from the above that for any family business wishing to remove their activities from a close company structure so that some or all of the shareholders (or persons connected with them) can succeed to the business and trade in their own right – be it as a sole trader, partners in a partnership or as members of a limited liability partnership – both condition A and condition B will apply.

It will be difficult to think of circumstances in which HMRC officials will be easily convinced that condition C does not also apply. This being the case, and depending on each shareholder's personal tax position, it can be seen that a tax rate of 32.5% (including the new 7.5% surcharge and assuming the £5,000 nil rate allowance has been used against real dividends) on the liquidation distributions will become the norm after 5 April 2016.

Not all readers may appreciate that the proposed new s 396B is to be self-assessed. Those pursuing the capital gains tax treatment despite the introduction of the new regime must be able to show that they have done so correctly.

Early exit strategy?

Clients whose use of corporate structures has been brought about by the policies (and indeed initiatives) of various governments may well be willing to explore winding up their company's operation and going down the members' voluntary liquidation (MVL) route in the 2015/16 tax year to ensure that the liquidation proceeds are paid out in the current tax year.

Let's say each shareholder is either an officer or employee of the company and can show that they own at least 5% of the issued ordinary shares as well as not less than 5% of the voting rights over the company. It is then to be expected that, if the company is a trading company and the facts of the situation have not changed for more than one year, each shareholder may be able to claim entrepreneurs' relief. Subject to the limit on the relief imposed by the lifetime allowance it will be assumed that the 10% rate will apply.

The mechanics of disincorporating a business as a going concern are numerous but an experienced insolvency practitioner will be able to help guide the directors through the commercial steps. Of course, the individual traders must advise the company's bankers what is being planned and negotiate any continuing lines of finance required for the new unincorporated business.

There will also be many practical issues to be addressed, such as leases and hire purchase arrangements. Consideration may need to be given to the value of stock and work-in-progress and the transfer of plant and equipment.

> ***"The test is whether the distribution is lawfully made by 6 April 2016."***

There will be many tax consequences within the company arising from the decision to remove a business as a going concern from a company. The company will be disposing of its assets – most likely by way of an *in specie* distribution by the liquidator to the shareholders – but the mechanics of this will need to be addressed in advance.

Take, for example, whether the company's goodwill is pre- or post-1 April 2002. A value must be placed on the goodwill of the business on the disincorporation date and be compared with the company's cost thereof (or written down value) to establish the taxable gain within the company on the disposal to the shareholders.

All the many practical and technical issues need to be thought through but the message in this article is that time is running out to organise matters.

It should be noted the test is not whether the liquidation was started before 6 April 2016 but whether the liquidator's distribution is lawfully made before this date. Thus, a liquidation which began on 1 March 2016 that results in two distributions to shareholders, one on 15 March 2016 and a further distribution on 8 April 2016, will result in two different tax treatments. The first distribution will be taken into account in arriving at the assessable capital gain for 2015/16 (and any possible claim to entrepreneurs' relief). But the amount of the distribution on 8 April 2006 will be taken into account assessable as a dividend in 2016/17 (having due regard to the initial subscription price of the shares) unless the taxpayer can demonstrate that Condition C is not met.

Transactions in securities

As explained in Pete Miller's excellent article 'What is going on?' (*Taxation*, 4 February 2016, page 16) significant changes are being made to the TIS provisions from 6 April 2016, but the existing provisions will continue for the remainder of this tax year.

It has long since been accepted that a transaction involving a business being transferred out of one company into another corporate entity would fall within the TIS provisions, even if the transfer was effected by means of an *in specie* distribution by a liquidator.

However, there is good news. HMRC officials have indicated that it is accepted that if a business is simply succeeded by a shareholder (either by way of a simple transfer from a company followed by its liquidation or by way of an *in specie* distribution by a liquidator thereof) who then begins trading as a sole trader or is succeeded by two or more shareholders who begin trading in partnership, including a limited liability partnership, the current trading in securities provisions are unlikely to apply. Practitioners should consider making a clearance application under ITA 2007, s 701 in advance of taking these steps.

Call to action?

In these seemingly increasingly litigious times practitioners will be well aware of the need to look over one's shoulder and ask: 'What would a reasonably competent accountant or tax adviser, possibly one who has advised on the incorporation of many family businesses for tax reasons, be expected by the courts to do in the current circumstances?' Such a practitioner would be expected not only to know the forthcoming tax changes in outline but to have a firm grasp of the implications of them, including their likely impact on a client-by-client basis.

Is there not a strong case to say that a proactive adviser will be expected to draw matters to the attention of his clients and ask for instructions to review their particular circumstances with a view to considering disincorporation? This does not require specialist skills or knowledge outside the domain of a general practitioner. Those who fail to take the initiative may be exposed to negligence claims when the full impact of taking no action becomes apparent in a year or two.

Any reader in general practice who is in doubt about the level of skill and expertise from which their clients can reasonably expect to routinely benefit from should take a quick look at their own website. Further, it is always possible that some mischievous lawyer might come up with the idea that publication of this article in *Taxation* has raised the bar on expectations. Just a thought.

To be on the safe side, practitioners should prepare a short letter to be sent to any clients trading through a company advising them of the impact of the proposed changes in both this area and alerting them to other changes in the pipeline flagged up in HMRC's discussion document dated 9 December 2015. Is the alternative to face the possibility of a penalty for inertia?

Conclusion

Although there is only a limited window of opportunity, there is still time to pose the question to each client trading through a company – arguably focusing first on those who have built up the largest accumulated reserves.

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