Don't dream it's over

Make sure that clients aren't left dreaming of entrepreneur's relief. PETER RAYNEY advises on obtaining this relief on liquidation.

Over the past year or so, I have assisted a number of owner managers to close down their companies on a tax-efficient basis. Many of these businesses were consultancy- or service-based with no obvious succession path or exit route. In most of these situations, the owner manager has wished to "retire" and draw out the company's funds at the beneficial 10% entrepreneurs' relief (ER) rate of capital gains tax. Some of these retirements were a little premature because the owner manager wished to pursue a different, "less stressful" career path.

Because the relevant companies were solvent, there were two ways of terminating the company.

- *Dissolution under Companies Act 2006, s 1000.* Until March 2012, this was a popular route because it avoided appointing a liquidator and was therefore cheaper. However, after the abolition of extra-statutory concession (ESC) C16, such dissolutions will normally prove unattractive for tax purposes. This is because the statutory replacement to ESC C16 – CTA 2010, s 1030A – is of little practical use. Broadly, capital gains treatment is now only available if the total distributions paid to all shareholders are less than £25,000. Thus, where the distributable amounts will exceed this, they will suffer income tax at penal dividend tax rates (effective rates of 25% or 30.56%, depending on marginal tax rates).
- *Members' voluntary liquidation under the Insolvency Act 1986.* Owner managers can wind up their company by passing a special resolution and swearing a statutory declaration of solvency under the Insolvency Act (IA) 1986, s 89. A members' voluntary liquidation requires a licensed insolvency practitioner to act as liquidator who will realise the assets, pay off all liabilities, and return the surplus to the shareholders. This is a more expensive process but, where the company has significant reserves, a voluntary liquidation will normally be the preferred route for tax purposes. However, some liquidators are now prepared to offer competitive rates, particularly where the company's balance sheet is "clean" (ie simply cash). A members' liquidation ensures that the relevant company's reserves and capital can be repaid to the shareholders as capital distributions for capital gains tax purposes, which generally qualify for the 10% ER rate. Thus, a members' liquidation will now be the normal route.

KEY POINTS

- The two main ways to terminate a limited company.
- Entrepreneur's relief and the trading requirement.
- The treatment of large cash balances in the company.
- "Phoenix" companies may be caught by the transactions in securities legislation.
- Members' voluntary liquidations will be more expensive, but should ensure entrepreur's relief.

A special resolution (at a general meeting) is required to place the company into a members' voluntary liquidation (IA 1986, s 84). Owner managers must be satisfied that the company is solvent and make a statutory declaration to this effect. This will normally be a formality for the type of company closures being considered here. The liquidation will start when the members pass the special resolution to wind up the company (IA 1986, s 86). Notice of the special resolution must be published in the *Gazette* within 14 days. The winding-up resolution will start a new corporation tax accounting period for the company. However, it should be noted that the commencement of the liquidation does not trigger any kind of deemed disposal for the company's shareholders.

Building a wall

Distributions made to shareholders during a winding-up do not count as income distributions for tax purposes (CTA 2010, s 1030). Instead, they are on the other side of the wall and are treated as capital distributions under TCGA 1992, s 122 and are therefore chargeable to capital gains tax. Strictly, the recipient shareholder is treated as making a disposal of an interest in their shares when they receive or become entitled to receive the capital distribution from the company (TCGA 1992, s 122(1)).

Where several capital distributions are made, these represent part disposals of the shares and an appropriate part of the share base cost is deducted against each part-disposal. Special rules in TCGA 1992, s 122(2) apply to prevent an immediate tax charge on "small" capital distributions.

WOODFACE CONSULTING LTD

Woodface Consulting Ltd (WCL) is 100% owned by Neil, who subscribed for its entire 100 £1 ordinary shares at par in June 2000. WCL has provided public relations consultancy services since 2000, with Neil and various subcontractors providing advice and support to a number of high profile clients.

In April 2013, shortly after his 50th birthday, Neil made a life-changing decision to retire and close WCL, because he wished to pursue a different career as a self-employed landscape gardener.

Neil took professional advice relating to the closure of "his" company. Given the substantial cash balance that had been built up in the company, Neil's advisers applied to HMRC under the non-statutory business clearance to confirm that WCL qualified as a trading company in the 12 months to 30 April 2013. This was duly confirmed by HMRC. An ITA 2007, s 701 clearance was also obtained to give certainty that HMRC would regard this as a normal liquidation and no counteraction under ITA 2007, Part 13 Ch 1 would be sought.

The trade ceased and a liquidator was appointed on 1 June 2013. On 30 June 2013, the liquidator paid out £876,000 – representing all WCL's reserves and share capital (after deducting liquidation and other professional costs) to Neil as a single capital distribution.

This will be treated as a capital gains tax disposal, which should qualify for the 10% ER rate because WCL and Neil would have satisfied the relevant ER conditions in TCGA 1992, s 169I(7) throughout the 12 months to 1 June 2013 (ie when the trade ceased).

Neil's capital gains tax liability (in 2013/14) would be £86,500 (with an ER claim), which is calculated as follows:

	£
Capital distribution	876,000
Less: Base cost	100
Capital gain	875,900
Less: Annual exemption	10,900
Taxable gain	865,000
ER CGT @ 10%	£86,500

It would have been disastrous if Neil had decided to extinguish his company via a Companies Act 2006-style dissolution. Because the amount distributed would exceed the CTA 2010, s 1030A limit of £25,000, he would have suffered income tax at the effective distribution rates of 25% and (above the £150,000 top-rate threshold) 30.56%.

In some cases, the liquidator may make an in specie capital distribution of an asset to a shareholder or group of shareholders. This will generally involve a deemed market value disposal of the relevant asset by the company (see TCGA 1992, s 17,). Furthermore, the recipient shareholder is also deemed to receive a taxable capital distribution equal to the market value of the asset (TCGA 1992, s 122(5)(b)). An in specie distribution of (UK) property tends to be much better than a sale to a shareholder from a stamp duty land tax (SDLT) standpoint. Because there is no actual consideration passing on an in specie distribution, the property can be transferred without any SDLT charge (FA 2003, Sch 3 para 1).

The feeling of liberation and relief

The legislation contains special rules for obtaining ER on capital distributions when funds are "liberated" from the company. This is because, even though a capital distribution is treated as a disposal of an interest in the shares and would therefore potentially qualify for this relief – see TCGA 1992, s 169I(2)(c), the company will invariably be unable to fulfil the ER "trading requirement" condition before the capital distribution (disposal).

The legislation therefore provides that, in such cases, ER is available provided that the recipient shareholder satisfies the relevant conditions in the 12 months before the company ceases to trade (which may be the date of a prior sale of the company's trade and assets) (TCGA 1992, s 169I(7)).

The relevant ER conditions are:

- the company must be a trading company (or a holding company of a trading group);
- the recipient shareholder must have held at least 5% of the company's voting ordinary share capital in their own right; and
- the recipient shareholder was an employee or director of the company (or fellow group member).

Furthermore, the relevant capital distribution must be made within three years of the cessation of trading (or, where appropriate, the date it ceases to be the holding company of a trading group). The three-year period should invariably give the company ample time to realise its assets.

A worked example showing the tax treatment of a capital distribution made after the cessation of a trade is shown in ***Woodface Consulting Ltd***.

Possessions are causing suspicion

Some care needs to be taken to ensure that the company can satisfy the "trading requirement" in the 12 months leading to the date of cessation. The ER rules are quite stringent in that they require the company to be wholly trading, although non-trading activities are ignored provided they are not substantial (TCGA 1992, s 165A (3)).

In all the "retirement" cases that I have worked on, the owner managers (and their accountants) were worried that

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the company's possession of a large cash balance would mean that the ER entitlement was suspect, particularly as the trade was about to be cease. While care still needs to be exercised with substantial cash balances, HMRC now appear to have adopted a more pragmatic approach. HMRC tend to accept that cash generated from a company's trading activities should not necessarily prejudice its "trading" status.

In this context, it may also be argued that the mere holding of surplus funds in a bank account does not amount to an activity in any case, using the authority in *Jowett v O'Neill and Brennan Construction* [1998] STC 482. Applying this principle, the holding of cash would be ignored. Furthermore, HMRC take the view that any surplus cash would have to be actively "managed" before it was considered to be a non-trading activity of the business. Consequently, if cash balances are applied and managed as investment assets, HMRC would treat them as non-trading items, which would therefore be subject to the 20% "safe harbour" rule.

Further support can be obtained from the important precedent laid down in *Farmer & Giles (Farmer's Executors) v CIR* [1999] SSCD 321 (an anonymised case involving a deceased farmer). Although the *Farmer* case involved the application of the inheritance tax business property relief (BPR) rules (which impose a different "wholly or mainly" test), the key principles developed in the case can usefully be applied for ER purposes. In *Farmer*, the Special Commissioner decided that the entire business had to be looked at "in the round". The fact that the property lettings were more profitable than the farming business was not considered to be conclusive – "the overall context of the business, the capital employed, the time spent by the employees and consultants, and the levels of turnover" all supported the finding that the business mainly consisted of farming. These principles were reaffirmed in the more recent inheritance tax BPR case of *HMRC v Brander (as executors of the will of the late Earl of Balfour)* [2010] UKUT 300. Interestingly, in that case, the Upper Tribunal placed far greater weight on turnover, profitability and the activities of the employees rather than the capital employed on each business activity.

In all the cases on which I advised, the main asset on the company's balance sheet was cash. Thus, given the importance in obtaining HMRC's acceptance that the company met the trading status requirement for ER in the 12 months up to the cessation, applications were made to HMRC under the non-statutory business clearance procedure. This entailed setting out the technical concerns "putting all the cards on the table" and then (using the above arguments) providing a reasoned basis for showing that the target company met the ER trading company test. In all cases, HMRC confirmed that the company was a trading company for ER purposes, notwithstanding the presence of large cash balances.

The shadows ahead

The practice of phoenixism, where new companies rise from the ashes of the old company under (broadly) the same management/ownership is generally frowned upon by HMRC where this is driven by (income) tax avoidance.

Some owner managers may be tempted to liquidate their company to enable the reserves to be extracted as a tax-efficient capital gain (as shown above), but they still intend to carry on the same business through a new company. This may cast a shadow over any ER entitlement.

In such cases, HMRC will invariably seek to counter the tax advantage – being the avoidance of income tax that would otherwise have been suffered on a normal dividend out of the company's profits – under the transactions in securities (TiS) legislation in ITA 2007, Part 13, Ch 1.

It is generally accepted that a liquidation of a company does not, of itself, fall within the definition of a TiS. This was originally confirmed by the attorney general's parliamentary statement in 1960 (when the original TiS legislation was introduced). However, HMRC have always taken the view that other arrangements or transactions surrounding the liquidation will trigger a TiS, such as the shareholders' liquidation agreement in *CIR v Joiner* 50 TC 449 or an issue of shares in a new company (as argued by HMRC in *Ebsworth v HMRC* [2009] FTT 199 (TC)).

HMRC's policy in this area is reinforced in its *Company Tax Manual* (at CTM36850). This shows that HMRC would seek to apply the TiS legislation where a company is wound up after the transfer of its business to the same shareholders (or those connected with them). However, the TiS rules should *not* apply to genuine liquidations (such as in Neil's situation – see example) where there has been a "clean" exit from the business and there is no intention to resume the same business through another company.

If HMRC successfully counteract the "tax advantage" under ITA 2007, s 684 they will issue a counteraction assessment under ITA 2007, s 698. The assessment would impose a quasi-dividend income tax charge on the amount represented by the company's distributable reserves. The shareholder would therefore suffer penal income tax rates at 25% and/or 30.56% (less a credit for any capital gains tax already paid).

In summary, unless the liquidation involves a clean exit from the business by the shareholders, most tax advisers would generally recommend obtaining an advance TiS clearance from HMRC under ITA 2007, s 701. Provided the full facts of the case are presented to HMRC, the s 701 clearance will provide certainty that the TiS rules will not subsequently be invoked by HMRC.

The end of the road

Probably the most important conclusion reached here is that owner managers wishing to close their companies will normally have to do this through a members' voluntary liquidation. This will be a more expensive exercise but, since the demise of ESC C16, it is the only way of reaping the substantial benefits of ER-relieved capital gains.

On the other hand, company dissolutions should now be restricted to those cases where the company has minimal assets so as to secure the limited protection of CTA 2010, s 1030A. In appropriate cases, tax advisers may also consider the possible benefits of simply paying dividends within the shareholders' basic rate bands over a number of years.

Peter Rayney FCA, CTA (Fellow), TEP runs an independent tax consultancy practice, Peter Rayney Tax Consulting. The new edition of his popular book, *Tax Planning For Family & Owner Managed Companies – 2013/14* (Bloomsbury Professional) will be published in the autumn.