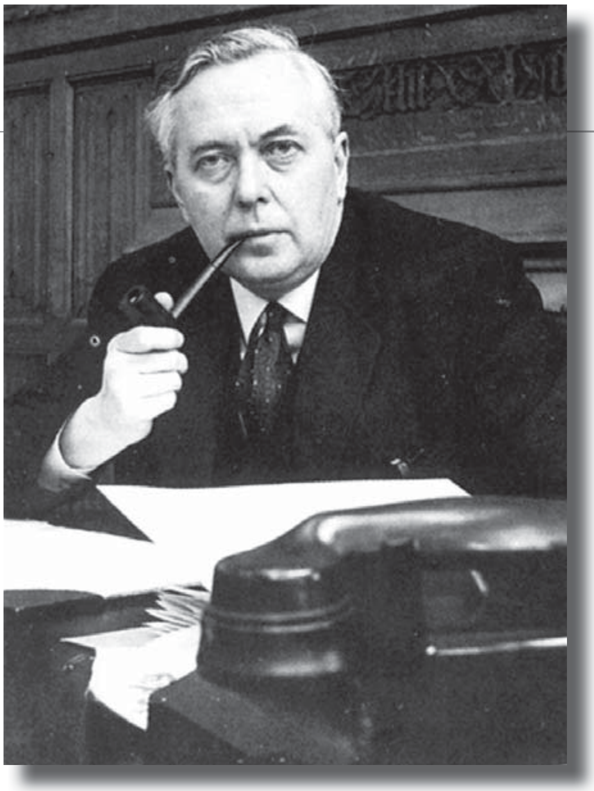


How can I BE SURE?

Peter Rayney considers the application of the TiS legislation to transactions by owner-managers

Understanding certain aspects of tax law can sometimes be greatly assisted by learning about their historical backcloth. The origins of the Transactions in Securities (TiS) legislation are a case in point. In the 1960 fiscal world, capital gains tax was not even a glint in the eye of the Parliamentary draftsman! So it was not surprising to find that fiscal alchemy was often at work, with large numbers of taxpayers seeking to convert highly-taxed income into exempt capital receipts.

The legislator responded by introducing various anti-avoidance provisions. One of the most important was the TiS provisions in *FA* 1960, s. 28, primarily aimed at dividend stripping and bond washing schemes. The Hansard record of the time makes interesting reading, displaying vexatious contempt for the work of the 'dividend stripping' alchemists. Harold Wilson (then in opposition) was sufficiently incensed to say that they robbed the 'Exchequer on a far vaster scale than all the smugglers who ever sailed the high seas'! (Hansard Standing Committee debate, 25 May 1960 (Col 582)).

Although CGT was introduced in 1965, the large gap between income tax rates and CGT rates meant that the TiS legislation (along with many other similar anti-avoidance rules) still had an important role to play.

The TiS provisions have been employed to combat a wide range of arrangements that seek to transmogrify income into (more favourably) taxed capital gains. Like many anti-avoidance rules, they are very pervasive and can potentially apply to innocent transactions as well as those HMRC consider unacceptable. However, the proposed reforms that HMRC announced in its Consultation Document (Condoc) on *Simplifying Transactions In Securities Legislation* (published in July 2009) should enable the application of the TiS rules to be more targeted in future (more of that later).

The original *FA* 1960 TiS provisions were consolidated into *ICTA* 1970, s. 460 to s. 467, and latterly in *ICTA* 1988, s. 703 to s. 709. Further changes took place in April 2007, so that

- *ITA* 2007, s. 682 to s. 713 applied the provisions in relation to income tax (ie, individuals and trusts);
- *ICTA* 1988, s.703 to s. 709 continued to apply to companies only.

Unless stated otherwise, all remaining statutory references will be to the income tax provisions in *ITA* 2007.

Can you feel the force?

We will concentrate on the TiS rules as they affect owner-managers, but we must first review the main triggers that potentially bring the legislation into play. Section 684 sets out the main circumstances, which are broadly summarised as follows:

- There must be a transaction in securities or TiS (which covers a wide range of transactions but would include a share sale).
- The taxpayer obtains a 'tax advantage' – HMRC look to see whether potential income receipts have been converted to 'capital'; ie, whether the proceeds could have been taken as a dividend that would incur an income tax charge. (Under s. 683 an income tax advantage can arise [among other things] where potential income tax is avoided or reduced.)
- That tax advantage is obtained as a result of the transaction falling within one of the prescribed circumstances in the legislation. As far as owner-managers are concerned, the main provision HMRC use to combat 'unacceptable' transactions is s. 689 (known as Circumstance D).

However, there is an important 'escape clause' in s. 685. Section 684 will *not* apply where it can be shown that the transaction was motivated by genuine commercial reasons and not tax avoidance. There is also a let-out for transactions that are carried out in the normal course of making or managing investments. Given the wide scope of the TiS rules, taxpayers will invariably apply to HMRC for an advance clearance that their TiS will be accepted as falling within the 'escape clause' (see below).

In practice, HMRC will only invoke s. 684 and issue a counteraction notice where the income tax on the relevant consideration (which is effectively taxed as a 'quasi-distribution' under the TiS legislation) is materially greater than the CGT liability on the same amount.

I can see *Cleary* now

The vast majority of family- or owner-managed company sales will fall within s. 689 – Circumstance D – (previously *ICTA* 1988, s. 704D). These provisions operate where (among other things) shares in an unlisted company are sold. (Listed companies are also caught if they are controlled by five or fewer persons.)

The real mischief is that cash is being taken out of a company without income tax being paid on it

For the transaction to fall within Circumstance D, the seller must receive the consideration without paying income tax on it, and that consideration must be or represent

- the value of assets available for distribution by way of dividend;
- the future receipts of the company; or
- the value of its trading stock.

The application of Circumstance D can easily be seen by examining the *Cleary* case (*Cleary v IRC* 44 TC 399) – see Table 1. It will be appreciated from *Cleary* that the real mischief is that cash is being taken out of a company without *income* tax being paid on it (since the taxpayer is seeking to obtain a capital receipt). In practice, HMRC generally accept that where shares are being sold to an *unconnected* third party, this would normally be regarded as a 'clean sale'. In other words, HMRC would be satisfied that the sale is being driven by commercial reasons and the main objective has *not* been to avoid income tax. The seller's consideration would therefore all fall within the CGT regime (with the potential benefit of entrepreneurs' relief and so on).

On the other hand, where shares are being sold to a 'connected/related' company for cash (and/or debt/loan notes), HMRC will tend to suspect that the sale is being undertaken to achieve a tax advantage. This is because income tax has been avoided on the cash extracted (since it is being taken in a capital form in the expectation that the sale proceeds would attract favourable CGT rates).

Many will be aware that HMRC has taken particular interest in the potential application of s. 684 to secondary buy-out transactions. Typically, in such cases, an existing venture capitalist wishes to realise its investment and a new 'replacement' investor is found. The new investor will form a new company (Newco), funded by a mixture of debt and shares. Newco will then purchase the target company, buying out the existing venture capitalist and management shareholders. In the vast majority of cases, the senior management team will retain its investment in the business by taking shares in Newco under the share exchange provisions in *TCGA* 1992, s. 135. However, if management is taking the opportunity to extract cash (or take loan notes), HMRC may view this as unacceptable since a 'tax advantage' may be obtained in the context of s. 684. Such transactions are viewed as potentially falling within the so-called *Cleary* principle, and HMRC will look at each case on its own merits in deciding whether the TiS rules should apply.

Make it easy on yourself

Parliament recognised that the TiS anti-avoidance rules had to be aimed widely, but they were never intended to apply to genuine commercial transactions. Unfortunately, the *current* legislation does not distinguish between so-called 'clean' sales or those made to connected companies – both fall within the widely drawn provisions. This is why we have the so-called 'escape clause', which excludes such transactions provided there is no main tax advantage motive (s. 685). Given the subjective nature of these tests, taxpayers were given an advance clearance procedure (now found in s. 701). This enables them to obtain agreement from HMRC that the relevant TiS meets the 'escape clause' tests *before* it is implemented.

Taxpayers must appreciate there are currently two *separate* tests to be satisfied. It is possible that a transaction may be conducted for sound commercial reasons yet still fail on the basis that a main tax avoidance motive is also present. This was demonstrated in the recent case of *Trevor G Lloyd v HMRC* (SpC 672). Even where the perceived tax advantage (such as the extraction of cash) is a relatively small component of a 'connected' share exchange deal, the Special Commissioner may still find that it is a main objective and uphold a TiS assessment (such as in *Snell v HMRC* [2008] SpC 699).

Section 701 clearance applications should be made to HMRC – Clearance & Counteraction Team. (It is possible to apply by email to reconstructions@hmrc.gsi.gov.uk – although this is not recommended for market/price-sensitive matters or well known individuals). A single advance clearance application should be made to cover all relevant 'tax clearance' requirements (for example, covering both TiS and TCGA 1992, s. 138).

The application should clearly explain the commercial reasons for the contemplated transaction or transactions and explain why there is no intention to obtain a (main) tax advantage. HMRC has a statutory obligation to respond within 30 days. It is important for the clearance to show all material facts and steps involved in the transaction. Any clearance based on an incomplete disclosure is likely to be invalid.

In practice, 'clean' exits will usually obtain clearance. These pose little or no tax 'risk' to HMRC and are generally cleared quickly. Since HMRC is mainly targeting connected party or 'internal' sales, one of the Condoc's key proposed reforms is to exclude the majority of 'clean' sales from the scope of TiS altogether (see below).

Don't look back in anger

Under the current TiS regime, it is generally sensible to apply for advance clearance. Obtaining advance clearance under s. 701 will give the relevant taxpayer(s) certainty that HMRC will not subsequently issue a counteraction notice.

Deciding *not* to apply for clearance exposes the taxpayer to a lengthy 'waiting' period. Since the TiS legislation falls outside the self-assessment regime, HMRC must raise the necessary assessment to counteract the 'tax advantage'. It has been confirmed that the six-year time limit for raising a s. 698 counteraction assessment will continue (and is not currently within the reduced *FA* 2008 'discovery' assessment window – four years). Income tax charged on a s. 698 counteraction assessment carries interest from the 31 January following the end of the year of assessment.

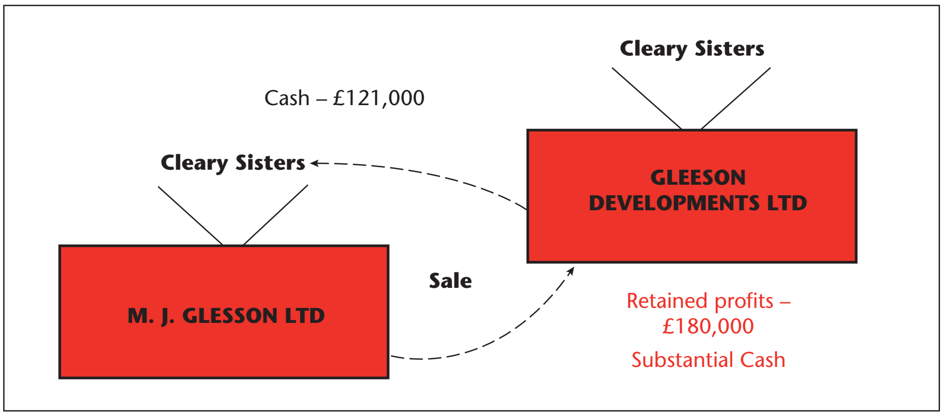
If a s. 698 assessment is raised, the taxpayer can then lodge an appeal against it within 30 days, stating the reasons for the disagreement. If the issues cannot be resolved, any appeal must now be made to the First-tier Tribunal (which replaces the former s. 704 Tribunal process). There is also a statutory right to request an internal review of HMRC's decision without resort to the First-tier Tribunal.

You really got me

Proposed sales where the seller is expecting to *receive cash (and/or redeemable loan notes)* may be refused clearance where the seller will continue to have a *material* economic stake in the business after the sale. Arguments that owner-managers sometimes use – that the sale is being made to 'combine' or 'merge' companies into a group – often hold little weight, since HMRC will sensibly enquire why the same transaction cannot be achieved by a share-for-share exchange. Sometimes, HMRC accept that shareholders with very small holdings (and therefore no influence) will not be in a position to obtain a tax advantage.

It is understood that clearances are refused only where a s. 698 counteraction notice would be taken based on the facts disclosed in the clearance (but this does not mean that a counteraction notice is served in *all* cases of refusal). Where HMRC seeks to make a s. 698 counteraction assessment under TiS (on the basis that it is not protected by the 'escape clause'), this must adhere to the principles in s. 699. This requires that the income tax cannot exceed the amount that would have been payable on a qualifying distribution of the company's *distributable* profits. Thus, if the company's distributable profits are lower than the sale proceeds received for the shares, the s. 698 charge will normally be restricted by reference to the amount

TABLE 1 THE *CLEARY* CASE



Two sisters owned Gleeson Developments Ltd (Developments) on a 50:50 basis and MJ Gleeson Ltd (Gleeson). The sisters needed some cash and Developments had substantial cash funds.

They therefore decided to sell a substantial part of their Gleeson shares to Developments. The shares in Gleeson were sold for their true market value of £121,000.

However, the Revenue issued a counteraction notice (under what is now s. 698) charging the entire £121,000 proceeds to income tax. The Revenue considered that the three preconditions for the legislation to apply were satisfied:

- The sale of the shares was a TiS.
- The sale fell within the prescribed Circumstance D – now in s. 689 (the sisters had received as capital an amount that represented the value of Developments assets that would have been available for distribution as a dividend, had it not been applied in acquiring the shares in Gleeson).
- There was a tax advantage – simply because income tax had been avoided.

The House of Lords agreed with the Revenue – the sale of the shares had come within the strict wording of (what is now) s. 684.

TABLE 2 – COMPUTATION OF S. 698 COUNTERACTION ASSESSMENT

Mr Davies was involved in a management buy-out in July 2007. He sold his 10% shareholding in the original 'Target' company for a cash consideration of £800,000 and shares in the acquiring company (Newco). These consideration shares in Newco gave him an effective 40% equity stake in the business going forward.

HMRC refused the company's s. 701 clearance application in respect of Mr Davies, although he did obtain TCGA 1992, s. 135 share exchange relief for the shares issued by Newco.

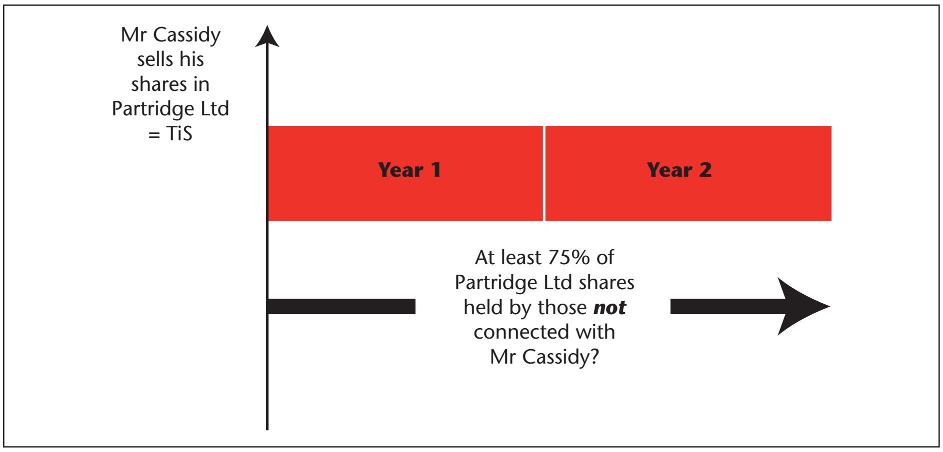
After negotiations with Mr Davies' advisers in summer 2009, a s. 698 counteraction notice (based on a qualifying distribution) of £600,000 is agreed. This produces the following tax liability:

	£
Deemed qualifying distribution	600,000
Add: Tax credit (1/9)	66,667
Gross dividend	666,667
Income tax @ 32.5%	216,667
Less: Tax credit	(66,667)
Tax payable	150,000

Mr Davies' July 2007 capital gain would be adjusted to be based on sale proceeds of £200,000 (£800,000 less net amount taxed under s. 698 of £600,000).

TABLE 3 – PROPOSED CHANGE OF OWNERSHIP RULE (FROM APRIL 2010)

Assume Mr Cassidy sells his shares in Partridge Ltd in (say) May 2010. He will satisfy the proposed 'change of ownership' rule provided he is not connected with 75% of Partridge Ltd's shareholders *at any time* in the two years following the sale (ie, up to March 2012), as illustrated below:



of distributable profits. This is because the TiS legislation (Circumstance D) targets the extraction of amounts that could have been taken as a dividend (s. 689 (3) (a)).

CTM 36855 indicates that HMRC will seek to make a counteraction assessment where the (relevant) CGT liability is materially less than the comparable income tax on the equivalent distribution. Given the current wide gulf between CGT rates and income tax rates, it is expected that assessments will often be made. Furthermore, with the 'super tax' distribution rate of 36.1% applying from 2010/11 onwards, the tax cost of falling foul of the TiS regime is likely to rise steeply!

See Table 2 (previous page) for an example illustrating how HMRC might compute a s. 698 assessment.

Take it to the limit

TiS is widely defined in s. 713. It can encompass, for example, a sale or issue of shares or securities or the alteration of rights attaching to shares or securities.

The Courts have given the meaning of a TiS a broad interpretation. Although it is not HMRC practice to treat an ordinary liquidation as a TiS, it will seek to apply the TiS legislation where other factors are present, as demonstrated in the case of *CIR v Joiner* [1975] STC 657. In that case, the House of Lords held that the TiS legislation applied where a shareholders' agreement varied the shareholders' rights before the company was liquidated. This enabled the company's main (75%) shareholder to continue to carry on the trade in a new company *after liquidation*, having extracted the old company's distributable reserves as capital (rather than income). HMRC will therefore seek to apply the *Joiner* principles to 'phoenix' arrangements where shareholders extract the company's reserves as a capital distribution on liquidation and carry on the *existing* trade through another company.

Back to the future

A number of refreshing reforms to the TiS legislation are proposed by HMRC in its July 2009 Condoc, which are likely to be introduced in April 2010. HMRC clearly recognise that the vast majority of s. 701 clearance applications are given on third party sales. It would therefore save time and compliance costs if such cases could be filtered out of the legislation at the outset.

The proposed solution is to exempt transactions from the TiS provisions where there is a 'fundamental change in ownership' after the relevant TiS. In broad terms, the fundamental change in ownership rule will be satisfied in relation *to each shareholder* where *throughout the two-year period* following the TiS (such as a share sale)

– at least 75% of the relevant company's shares are held by 'third parties' who are *unconnected* with them;
– these shares carry at least an entitlement to 75% of the distributions that may be made by the company (and at least 75% of the voting rights).

These principles are illustrated in Table 3 (left). The 75% rule is based on current HMRC practice, which is to grant clearance in those cases where there is a 75% change in ownership. The two-year period test ensures that the change of ownership is sufficiently permanent.

Further key proposals in the Condoc include:

- Adopting the close company definition for circumstance D – which is uncontroversial and also enables HMRC to curb so-called 'D-proofing' schemes that seek to avoid the TiS rules.
- The removal of the 'commercial purpose' condition so that the TiS provisions would be triggered where (among other things) obtaining a tax advantage is the main or one of the main purposes driving the relevant transaction. HMRC has indicated that failure to pass the new 'fundamental change of ownership' test will not of itself cause a transaction to be caught. Each case would be looked at on its own merits to determine whether 'obtaining a tax advantage' was a main driver or one of the main drivers. In my view, the retention of a complemetary 'commercial purpose' test would enable HMRC and the appellate bodies, etc, to focus on the commercial reasons rather than simply seek out the potential tax avoidance ones.

However, on balance, HMRC's proposed surgery to the TiS rules should be welcomed by owner-managers. In particular, the introduction of a 'fundamental change of ownership' rule should give them more comfort that HMRC cannot invoke TiS on share sales to third parties. On simple sales, this is likely to reduce the need for clearance applications. However, applications will still be needed under *TCGA* 1992, s. 138 (for example where shares, loan notes, or deemed *TCGA* 1992, s. 138A securities form part of the sale consideration) or where there is a company demerger or reconstruction.

Peter Rayney FCA CTA (Fellow) TEP runs Peter Rayney Tax Consulting Ltd and can be contacted at peter@prtaxconsulting.co.uk