

Distributions in a winding up

(Lecture B1059 – 19.42 minutes)

As predicted, it is becoming increasingly clear that the targeted anti-avoidance rule (TAAR) introduced by FA 2016, which applies with effect from 6 April 2016 to certain distributions made on a winding up, is causing uncertainty for many businesses and is affecting investment decisions. This is particularly the case for companies in the property sector where it is a common practice for each development to be structured within a new company, usually for commercial reasons involving the financing of the development and the ring-fencing of liabilities.

The CIOT have explained the problem as follows:

‘(This) uncertainty is caused by the broad scope and consequent perceived lack of clarity in the legislation and we understand that this, combined with the limited examples in HMRC’s guidance, is leading to investment delays. It has been reported . . . that some taxpayers are reluctant to invest in new projects if there is uncertainty around the after-tax proceeds that they will receive (both on existing projects, which were in place before the TAAR was introduced, but also on future investments). As a result, plans for future projects can be on hold until the taxation of an earlier project is resolved.’

HMRC’s response to the CIOT’s concerns, first expressed in the summer of 2016, was to say that they would be publishing comprehensive guidance using a variety of examples to demonstrate the type of transactions to which the TAAR should and should not apply. However, this did not materialise until July 2017, more than 15 months after the starting date for S396B ITTOIA 2005 – the relevant details can be found in Paras CTM36300 – CTM36350 of the Company Taxation Manual. The opinion of most of those who have reviewed the published guidance is that it is far too brief and lacks constructive, useful and practical case studies. What is especially disappointing is that none of the scenarios that the CIOT provided in their earlier correspondence as being suitable for guidance have been included. For example, there is no mention of the impact of the new rules on companies used for a single major property development. The result is that the guidance is hardly helpful in mitigating the uncertainties of the legislation.

Para CTM36350 deals with requests for clearance and confirms that there is to be no formal or informal pre-transaction clearance procedure for the TAAR. The paragraph goes on to explain that, although the transaction in securities legislation does provide a statutory clearance procedure at S701 ITA 2007, a clearance given on a distribution in a winding up under this section does not extend to S396B ITTOIA 2005. In view of the similarity of the wording in the motive tests in the transaction in securities legislation and in the TAAR, it would be helpful to have established when HMRC would seek to apply the TAAR in circumstances where a S701 ITA 2007 clearance has been granted following disclosure of the full facts.

It is understood that difficulties are arising in practice where the shareholders of the company being wound up are individual trustees who may have connections to other companies carrying on the same or a similar trade. It would be useful if a relevant example could be added to HMRC’s guidance in order to help taxpayers understand when the TAAR might apply to a winding up involving trustee shareholders.

Two commonly occurring sets of circumstance are considered below. They cover:

1. a gradual retirement from business; and
2. the winding up of a corporate partner.

In neither case is the guidance clear as to whether or not the TAAR will apply.

Illustration 1

Jeremy, aged 68, is a consulting engineer who wants to wind up his company with a view to retiring. He knows that he will pick up some occasional work as a sole trader during the course of this process (including a substantial, albeit short-term, project abroad).

It seems clear that, on the winding up, Conditions A, B and C of the TAAR (see S396B(2) – (4) ITTOIA 2005) would be met, given that Jeremy will continue to work in a similar way as a sole trader. However, it is doubtful whether Condition D of the TAAR (see S396B(5) ITTOIA 2005) would apply in these circumstances.

Jeremy's main aim is gradually to retire from business. In view of this, he has decided to avoid the administrative burdens of running a company, although continuing to undertake occasional work as a sole trader. As a result, he may actually be subject to increased taxation, given that the higher income tax rates will be in point for his sole trader operation. If he had kept his company going, the revenue received would have been subject to the 19% corporation tax rate.

Arguably, the winding up of Jeremy's company does not result in an income tax advantage when looking at the future taxation of profits from his business, as Condition D requires. This particular winding up gives rise to a charge to income tax (and, were Jeremy younger, Class 4 NICs) which would not have resulted if the trade had been run to extinction within the company, with the profits being retained until the company's final liquidation. Similarly, if the company had not been wound up and had paid out all its profits as dividends, the overall income tax liability could have been smaller in the light of the £5,000 dividend tax-free allowance and the lower income tax rates for dividends in excess of this limit.

In considering whether it is reasonable to assume that one of the main purposes of the winding up is the avoidance or reduction of a charge to income tax, is the fact that the post-winding up activity was foreseen and was virtually indistinguishable from that previously carried on by the company at all relevant? Surely the key factor in this gradual retirement scenario is Jeremy's intention to stop working so that, even if there was a tax advantage arising from the winding up of the company, that would be a secondary concern.

Given that phased retirements are quite common in practice, should they not be specifically addressed in the TAAR guidance?

Illustration 2

Prior to the FA 2014 changes in the tax rules involving corporate partners, it was not uncommon for family partnerships (particularly in farming) to have a corporate partner.

If such a corporate partner is now to be wound up, presumably Conditions A, B and C will be satisfied if the partnership continues to be operated by the shareholders or their connected parties. However, it is not clear that Condition D would be met in this scenario. For example:

- The main motive for the creation of the original corporate partnership structure was tax planning – usually the avoidance, at the time, of a 50% income tax charge – and so the winding up of the company will mean that more tax will be payable in the future.
- In a similar vein to Illustration 1, the winding up will result in a greater charge to income tax on the remaining partners which would not have arisen had the corporate partner remained in situ. This makes it difficult to conclude that a main purpose of the winding up was the avoidance or reduction of income tax.

When looking at whether Condition D has been met, it is uncertain from the TAAR legislation and guidance what weight (if any) needs to be given to the motive for setting up such a structure, any past savings from it and the potential future increase in taxation. Further guidance on this point would be invaluable.

Contributed by Robert Jamieson