A wide range

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Tom Klouda and *Andrew Herring* consider the broadening in scope of the TiS legislation

Key Points

What is the issue?

The Transaction in Securities (‘TiS’) legislation continues to be relevant for individuals extracting value from private companies, including private equity structures.

What does it mean for me?

In recent years, TiS has broadened in scope. In particular, relevant consideration is much more widely construed than ever before, widening the potential tax exposure for those individuals who might be caught by the rules.

What can I take away?

Tax payers extracting cash from private businesses should continue to take extra care, when considering structures with an international element.

The original TiS legislation was first introduced in 1960 and was designed to prevent arrangements that allowed individuals to turn income into capital receipts. The provisions were introduced at a time when there was no capital gains tax and, therefore, receipts of a capital nature avoided the potentially high levels of income tax on dividends at the time.

Under these circumstances, it was advantageous for individuals to receive amounts in a capital rather than an income form. Unsurprisingly, the tax authorities at the time wished to ensure that this disparity in the tax regime was not exploited. The TiS provisions therefore sought to counteract any advantage gained by taxpayers receiving capital amounts, which otherwise would have been paid as income. The leading tax case applying to the early incarnation of the TiS provisions is *CIR v Cleary*.

Although the Cleary case is over 50 years old and the TiS legislation has since altered, it remains an important landmark in the application of the TiS legislation with the case still providing one of the simplest examples of the types of transaction the TiS provisions are intended to counteract.

In the case of *CIR v Cleary,* the transaction involved a cash sale of one company to another, where both companies were owned by the same sisters. Instead of a distribution of profits, the purchase of one company by the other allowed the capital realisation of cash held providing an income tax advantage for the sisters.

The rules today

Over the years, the tax landscape has changed dramatically with the rates of tax on dividend income and capital gains being much closer aligned. However, a tax differential between the two still remains with dividends currently taxable at 38.1% for additional rate taxpayers and capital gains taxable at 20%, or potentially 10%, if a relevant gain qualifies for Entrepreneurs’ Relief. HMRC is, therefore, still keen to tackle transactions which it perceives to gain an ‘income tax advantage’.

The TiS provisions are now aimed at a far narrower set of transactions than when originally drafted. Changes brought in over the last 20 years or so have removed a large proportion of transactions from the legislation. For example, the TiS provisions will not apply where there is a fundamental change in the ownership of the company (when the original shareholders do not control 25% or more of the ordinary share capital after the transaction). Additionally, the TiS rules are only applicable to close companies, those controlled by five or fewer participators, directly or indirectly. The fundamental change of ownership exclusion and the close company requirement has, therefore, removed many commercial transactions from the scope of TiS.

Despite this gradual trend in narrowing the focus of the TiS legislation, in recent years the legislation has begun to widen its scope again. Along with the recent general expansion of tax avoidance legislation, the TiS legislation has undergone some important amendments in recent years, most notably in Finance Act 2016.

Accordingly, there are a number of taxpayers who still need to pay close attention to the TiS provisions with the shareholders of private companies, such as owner managed and family businesses all likely to be close companies subject to the TiS rules on a transaction. In addition, companies backed by Private Equity houses will likely fall within the TiS rules as the significant stake held by the Private Equity investor means that the investee company is likely to be a close company.

Overview of rules

Broadly, the current TiS rules set out that a shareholder will be within the TiS rules if:

- they are party to a transaction (or transactions) in securities (e.g. a sale or transfer of shares);
- one of the prescribed circumstances applies;
- there is a ‘main purpose’ of securing a tax advantage; and
- they obtain an income tax advantage.

Broadly, the ‘prescribed circumstances’ require there to be a transaction in securities involving a close company, as a result of which the individual concerned receives ‘relevant consideration’ in a way which is not taxable as income.

‘Relevant consideration’ broadly means consideration up to the value of a corporate group’s retained profits, which, in simple terms, can be interpreted as the value of reserves available for distributions as a dividend. Therefore, the amount of any income tax advantage is potentially capped at the level of a hypothetical dividend, which could have been paid at the time of the TiS.

The broadening of relevant consideration

Finance Act 2016 brought in changes to the TiS legislation that could dramatically expand the potential tax exposure under a counteraction under TiS. As noted above, any counteraction by HMRC of an income tax advantage is restricted to the ‘relevant consideration’, as a dividend at the time of the transaction.

Prior to Finance Act 2016 this was restricted to the distributable reserves of the company in which an individual held the relevant securities. Therefore, if the company holding the securities had limited distributable reserves, any ‘income tax advantage’ available would be equally limited.

In short, the inability of a company to pay a dividend would mean that no income could have been received by a taxpayer in the stead of any counteracted capital receipt. However, Finance Act 2016, amended the definition of ‘*relevant consideration’ in ITA 2007 s.685 (7B), to include ‘… assets which are available for distribution to the company by way of a dividend by any other* ***company it controls*** ’.

This is clearly a much broader definition. Not only are the distributable reserves of the company subject to the TiS relevant, but the distributable reserves available to companies controlled by the company subject to TiS must also be considered.

This definition does not consider whether a dividend could actually legally be paid, e.g. there may be ‘dividend blocks’ between the reserves of a subsidiary company and the parent company. Additionally, the definition ignores the possibility of negative reserves in the group as a whole. On a group basis a corporate structure could have negative reserves, yet have a single subsidiary with positive reserves.

Even though, from an accounting perspective, a shareholder may not immediately be able to receive a dividend, arguably the amended legislation exposes an individual to the income tax charge based on the possibility of a distribution being made available from further down a corporate structure. It will be interesting to see how HMRC deals with these situations in practice.

Taxpayers considering the TiS rules must, therefore, look far wider at the relevant company’s group structure to ascertain their exposure to any TiS risk.

International element

The broadening of the definition of relevant consideration is further complicated when considering structures which have an international element.

The TiS legislation is applicable to UK tax resident individuals, regardless of where in the world a relevant transaction takes place. Securities held by UK taxpayers in non-UK resident companies are, therefore, still within the remit of the TiS legislation.

The case of *Rae v Lazard* maintains the principle that the nature of amounts received by UK taxpayers from overseas corporate entities, is dependent on the provisions of the local corporate law applicable, e.g. whether it is income or capital, and not how a similar payment would fall under UK law.

Furthermore, with the broadening of the definition of relevant consideration now applying on a group wide basis, individuals holding securities in UK companies, which have overseas subsidiaries, need to take account of any overseas availability of distributable profits.

A number of private equity structures and privately owned companies will utilise overseas jurisdictions in their investment or corporate structures. Overseas jurisdictions do not necessarily follow the same corporate accounting or legal practices. The impact of differing legal or accounting treatment in overseas jurisdictions may make it difficult to determine the amounts available for distribution.

For example, a Jersey company is not required to have distributable reserves for it to be able to pay a dividend. Jersey corporate law has a solvency-based regime for dividends, whereby Jersey companies may make a distribution based on a 12 month look-forward statement of solvency by the directors. A Jersey company may also fund a distribution from any account of the company, such as share premium, except for capital redemption reserve.

This is a much broader category of distributable reserves, in comparison to UK corporations. Therefore, when looking at structures with non-UK companies, the amount of relevant consideration could be far greater and care needs to be taken. This position is further highlighted with the widening of the definition of relevant consideration brought in by Finance Act 2016.

For completeness, ITA 2007 s 685 (7A) does provide that assets available for distribution can be ignored for the purposes of computing an income tax advantage where a distribution can be made solely because the local company law allows such a distribution. However, this provision is difficult to interpret and possibly has a very narrow application. HMRC Manuals do not cover this position, but this specific exclusion could relate to the reduction of capital of a profitable company where that payment might be either a return of capital or represent distributable reserves.

Application

There should be no counteraction under TiS where a transaction is being carried out for a genuine commercial purpose, specifically where gaining an income tax advantage is not the main, or one of the main, purposes of a transaction. However, given that what constitutes the main purpose of a transaction is a subjective matter, open to HMRC interpretation, the expanded definition of relevant consideration should weigh considerably on the assessment of the tax risk and exposure of a transaction.

When extracting cash from a group, where there is no fundamental change of ownership, the TiS rules need careful consideration.

For example, where a ‘NewCo’ is used to acquire a group, either realising value for existing shareholders and management, or to extract cash following a re-financing, where there is no fundamental change in control and the more obvious comparator transaction would have been a dividend, the subjective question of the main, or one of the main, purposes of the transaction is key.

In particular, private equity backed companies or private companies undergoing transactions where cash or other assets are being extracted, should be wary of the expanded scope of the TiS rules.

Reliance on a single company’s inability to declare a dividend can no longer provide comfort to UK individuals in assessing their exposure from a counteraction under the TiS provisions.

Conclusion

Despite being ‘narrowed’ since their inception, for transactions that are still caught by the TiS rules, they are deceptively wide ranging.

With the introduction of the expanded definition of relevant consideration, taxpayers can no longer rely on a lack of distributable reserves at the top of a structure to limit the extent of an available income tax advantage.

Structures involving non-UK entities should pay even closer attention to the impact of TiS on a transaction with the position often more nuanced than on first glance.