Increasing in scope

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Philip Simpson QC examines the changes made to transactions in securities by FA 2016, and explains how unexpected tax charges can arise

Key Points

What is the issue?

The issue is changes made to the transactions in securities provisions by FA 2016, clarifying and extending their scope. The enquiry procedure has been streamlined and two targeted anti-avoidance measures, aimed at liquidations/phoenix companies, introduced.

What does it mean to me?

The scope of the provisions means that advisers have to be aware in scenarios involving close companies of the potential for the transactions in securities provisions to give rise to unexpected tax charges. This potential has been increased by the changes made by FA16.

What can I take away?

The key practical points to take away are the extension of the rules so that liquidations in themselves count as transactions in securities; a tax advantage that accrues to a person who is not a party to a transaction in securities can still engage the legislation; distributable reserves blocked by a holding company are now relevant; and beware of scenarios involving the solvent liquidation of a company and the transfer of its business to a new company.

Currently, and for most of the lifetime of income tax, income has been taxed at higher rates than capital receipts. The transactions in securities provisions, now nearing 60 years old (the first tax year they applied was 1960/61), seek to prevent taxpayers from receiving in the form of capital what would, in normal course, be received in the form of dividends. The provisions relating to income tax have been both clarified and broadened by Finance Act 2016. There are similar provisions in relation to corporation tax: CTA 2010 Part 15. However, these have not been amended by FA 2016. Therefore, this article will not cover them.

One general point is that for the provisions to apply, there must be a close company involved at some point (including foreign companies that would be close if UK resident). Accordingly, in scenarios involving only non-close companies, the provisions may safely be ignored.

General approach

When first enacted, the core focus of the provisions was certain more obvious types of device. So, for example, one of the first cases was *Inland Revenue Commissioners v Parker* [1966] AC 141. A close company resolved to capitalise some of its profits, and to use them to pay up debentures that it then issued to its shareholders. The House of Lords ultimately held that the redemption of the debentures, some years later, was a transaction in securities that fell to be counteracted. In his speech, Viscount Dilhorne mentioned an argument in the Court of Appeal that the provisions had been aimed at ‘dividend stripping’: that is, where a person who is exempt from income tax purchases shares on which a dividend is about to be paid, receives the dividend, and then sells the shares back to the original holder. The original holder receives a capital payment in place of the dividend, and there is no income tax for the purchaser to pay on the dividend. Viscount Dilhorne said that regarding the provisions as directed at dividend stripping only was, ‘taking too narrow a view’. Instead, they were directed simply at tax avoidance ‘in certain circumstances’, those circumstances being as set out in the legislation and not being circumscribed by any external factor restricting their scope to any particular category of transaction in securities.

Thus, for example, if I create a trust whose beneficiaries are my spouse and I, and settle in it my 100% shareholding in an investment company with significant cash and distributable reserves, a sale by the trustees followed by a capital distribution to my spouse may be caught by the provisions, regardless of whether the buyer has the company pay a dividend, liquidates the company, or otherwise.

Five conditions

Turning to the substance, the legislation lays down five conditions to be met before a tax advantage can be counteracted.

The first is that a person must be a party to a transaction in securities. A non-exhaustive list is provided: ITA 2007 s 684(2). The list is extensive. But there are limits.

In *Inland Revenue Commissioners v Joiner* [1975] 1 WLR 1701, a close company was put into voluntary liquidation. Its business was sold to another company owned by one of the close company’s shareholders. The shareholders in the close company entered into a liquidation agreement as regards how the company’s assets were to be distributed in the liquidation. Accordingly, the shareholder in question received assets different from what he would have received had the liquidator simply divided the assets among the shareholders in the normal way (most likely by converting them all into cash and distributing the proceeds pro rata). The House of Lords recognised that the arrangement was standard tax avoidance planning to extract the company’s distributable profits tax-free while the business was continued. One question was whether the liquidation itself was a ‘transaction in securities’. The legislation at that time referred to the combined effect of ‘two or more [transactions in securities]’ and the combined effect of a ‘[transaction in securities] and the liquidation of a company’. That wording forced the House of Lords to the conclusion that a liquidation itself was not a transaction in securities. Thus, for example, if a business operated by a company were sold to a third party and the company liquidated, the fact that the company’s assets were distributed in the course of the liquidation rather than first being paid out (so far as distributable) by way of dividend could not be caught by the legislation. By contrast, if the company’s business were sold to another newly-incorporated company owned by the same shareholders, the liquidation could be combined with the issue of shares in the new company to engage the legislation.

One other limitation on the scope of the concept ‘transaction in securities’ was considered by the House of Lords in *Inland Revenue Commissioners v Laird Group plc* [2003] 1 WLR 2476. In that case, a company purchased a subsidiary. It then paid a dividend to its own shareholders, incurring an advance corporation tax liability. It had the new subsidiary pay it a dividend, as franked investment income, thereby enabling it to set off the franked amount against its own ACT liability. Before the House of Lords, the issue narrowed to whether a distribution made by a company not in liquidation was a ‘transaction in securities’. Lord Millett, giving the leading speech, held that it was not. Lord Millett asked first why a liquidation should not be a ‘transaction in securities’. He concluded that it was, ‘not a transaction relating to securities because neither the shares themselves nor the rights attached to them are affected by a payment which merely gives effect to the shareholders’ rights; they receive only what is already theirs.’ As no material distinction could be drawn between a distribution in the course of a winding up and a distribution while the company continued as a going concern, the latter was not a 'transaction in securities'. Therefore, no counteraction measure was justified in the case.

FA 2016 extends the definition of 'transaction in securities' so as to include a distribution in respect of securities in a winding up: in other words, a liquidation is itself a transaction in securities. Of course, this provision does not negate the conclusion in Laird Group, that a distribution by a continuing company is not a 'transaction in securities'. Whether the extension to include distributions in a winding up has any practical effect is not clear: it is difficult to imagine any circumstances in which a liquidation on its own could justify counteraction measures. None the less, the change has been made.

The second condition may be met in two different ways. Either (i) the party to the transaction in securities must receive money representing assets of a close company available for distribution, or representing future receipts, or representing trading stock, in connection with the distribution, transfer or realisation of the company's assets, or the application of those assets in the discharge of a liability; or (ii) the person must receive shares or securities issued by a close company, including if in connection with the transaction in securities or a transfer by a close company of assets to another close company, where the shares or securities received representing assets available for distribution or trading stock. As regards condition (ii), there must be two or more close companies involved in the transaction. In either case, the condition is satisfied only if the recipient does not bear income tax on the receipt.

A typical case might be a close company with distributable reserves. Its owner also owns a second close company. Instead of having the first company pay a dividend, the owner arranges for it to be bought by the second company. The price is left outstanding. After the sale, the first company lends money to its new parent, and this money is used to pay the price for the shares. This meets condition (i). If the debt consisting of the price were formalised in loan notes, the case would be within condition (ii). But there was a lacuna in the legislation: if the company that was sold was itself a holding company with no distributable reserves, the fact that it had subsidiaries with distributable reserves would not bring it within the legislation. So FA16 amends the position so that distributable reserves of a company controlled by the close company engage the provisions.

The other amendment in this regard is in relation to foreign companies. Foreign companies are within the provisions if they would be close companies if UK resident. But some foreign jurisdictions permit a return of capital to be made by way of distribution. Thus, the money is 'available for distribution by way of dividend' and within the literal meaning of both conditions. Prior to amendments made in 2010, this exception applied in relation to what counted as 'relevant consideration'. So, for example, the redemption of share capital by a foreign company with no distributable reserves was not brought within the provisions merely because the applicable foreign law permitted amounts representing that capital to be distributed. Amendments in 2010, not intended to effect any change, altered this so that it applied literally to the assets distributed, realised etc., and only possibly, by one reading of the provisions, to relevant consideration. So, for example, if a UK subsidiary of a foreign company repaid capital to its parent, and the parent, having no distributable reserves, used the proceeds to repay capital to its UK shareholders, a transactions in securities charge could have arisen if the foreign law permitted share capital to be distributed by way of dividend. But FA 2016 makes it clear that the exception applies only to what counts as relevant consideration. Thus, in that example the transactions in securities provisions would (rightly) not apply. The concept of 'relevant consideration' is important in relation to the amount of any assessment under these provisions. Thus, the clarity this amendment brings is beneficial to taxpayers.

The third condition is formulated as an exception. The provisions do not apply if there has been a 'fundamental change in ownership' in the close company in question. The reason is that the provisions are not designed to transform genuine disposals of shares in companies into dividends followed by disposals. Previously, the condition required that for two years following the transaction, at least 75% of the ordinary shares, rights to dividends and voting rights in the close company be held by someone other than the taxpayer and connected persons. Thus, for example, the condition was met, and the legislation inapplicable, if a person who owned 26% of the shares sold 2%, reducing the shareholding to 24%. The legislation has been turned round by FA 2016 to consider the issue from the point of view of the original shareholders. This has significantly reduced the scope of the exclusion (and correspondingly broadened the scope of application of the provisions). This is because the requirement is now that no original shareholder, together with associates, may hold more than 25% of the shares, dividends or voting rights in the company. Thus, in the above example the provisions would not be excluded, if the 74% of shares not owned by the party to the transaction were owned, and continued to be owned, by another unconnected individual. Moreover, the concept of ‘associates’ is in some ways wider than elsewhere. For example, the relationship between the settlor of a trust and the trustees is one-way in terms of connected persons (see section 448 CTA 2010, so that a settlor is an ‘associate’ of the trustees of the settlement in question, but the trustees are not an ‘associate’ of the settlor), but two-way so far as ‘associates’ is defined for the transactions in securities provisions. So their shareholdings have to be aggregated in this context.

The fourth condition is that a person must have obtained a tax advantage. Again, this condition has been (probably) enlarged, so that a tax advantage obtained by a person who is not a party to a transaction in or relating to securities counts to engage the legislation. For example, returning to the scenario of a person settling shares in an investment company into a trust of which the settlor and the settlor’s spouse are beneficiaries, where the trustees sell the shares and appoint the proceeds as capital to the settlor’s spouse, the spouse is not a party to a transaction in securities (s/he may be a party to a transaction ‘relating to securities’, depending on how widely one interprets that phrase). The settlor obtains no income tax advantage; nor do the trustees, as any income of the trust is deemed transferred to the settlor by the settlements legislation. The person who could be said to obtain an advantage is the settlor’s spouse, who receives a tax-free capital payment that could have been received as a taxable income payment instead. Whereas previously that might not have been enough to engage the legislation, it now clearly meets this fourth condition.

Finally, FA 2016 requires that one of the main purposes of the person in entering the transaction must have been to obtain an income tax advantage. This has not been changed. It is worth mentioning that it focuses on the intention of the party, rather than an objective analysis of the transaction; however, the courts will take an objective approach to ascertaining a person’s intention, so it is not possible to escape the provisions by claiming a subjective intention to achieve some purpose other than avoiding tax.

Amount of assessment

The amount of the assessment is, in short, the amount by which the income tax that would have arisen on a distribution equal to the ‘relevant consideration’ (the money received by a person, not necessarily the person who is party to the transaction in securities) exceeds any capital gains tax in fact paid. The ‘relevant consideration’ is limited to such amount as could have been received by the taxpayer by way of distribution from the company.

Procedure

If HMRC decide to investigate a taxpayer’s affairs because they suspect counteraction under the transactions in securities provisions may be justified, the procedure for doing so was previously cumbersome. It has now been streamlined.

Previously, if an HMRC officer believed a transaction to be caught, s/he had to issue a preliminary notification to the taxpayer. The taxpayer was entitled to respond. The HMRC officer then had to transmit the notification and the response (if any) to the First-tier Tribunal for a prima facie determination. If the Tribunal determined prima facie that the provisions applied, the officer was free to take counteraction measures. Otherwise, no counteraction measures were competent. Once counteraction measures were taken, the taxpayer could appeal to the Tribunal in the normal way.

Now, the preliminary procedure has been abolished. The position is aligned with the normal enquiry and closure notice procedure (though as the transactions in securities provisions are not liable to self-assessment, the time limit for opening an enquiry is longer than normal, at six years). Thus, if an officer believes the provisions may apply, s/he may open an enquiry. The enquiry will be closed by closure notice and assessment. The taxpayer may then appeal in the normal way.

Clearance

There is a procedure for obtaining clearance from HMRC in advance of entering into transactions that might be caught by the provisions. This has not changed.

New targeted anti-avoidance rule

By way of post-script, as part of the amendments to the transactions in securities provisions there has been introduced a new targeted anti-avoidance rule. It is aimed at phoenix companies, that is where a company is wound up and the business transferred to a new company, with no other significant change. These provisions have been introduced into ITTOIA 2005, as new sections 396B and 404A.