

Wind Up Woes?

Ken Moody looks at the anti-avoidance rules potentially affecting the tax treatment upon the winding up of a company.

Getting money out of a company without paying income tax, short of winding up, has always been difficult, but even the automatic capital treatment of distributions in winding up may now be problematic in some situations.

Out of the ashes...

FA 2006 inserted a new s 396B ('Distributions in a winding up') into ITTOIA 2005, explicitly to deter 'phoenixism' – a strategy of accumulating funds in a company, liquidating the company and extracting the funds as capital distributions (and paying capital gains tax (CGT) hopefully at only 10% with the benefit of entrepreneurs' relief) and then starting up a similar business in a new company.

The legislation is subject to four conditions (A to D) which, if met, means that the capital distribution received will be treated as a dividend. Conditions A and B will inevitably be met by an individual shareholder with an interest of at least 5% on receiving a capital distribution during the winding up of a close company. Condition C is that *within two years* of receiving the distribution the individual is 'involved with' a 'similar' trade or activity.

The individual's involvement may be as a sole trader, a member of a partnership, as a company shareholder (having an interest of 5% or more), or in a trade or activity carried on by a connected individual.

What is caught?

Two main questions arise, however:

- (1) what is regarded as a 'similar' trade or activity; and
- (2) what is meant by 'involved with'.

HMRC have published guidance on these two issues in the Company Taxation manual (at CTM36325 and CTM36330), giving as examples a landscape garden designer winding up her company and then trading personally as a gardener; and a builder who runs two companies, one specialising in loft conversions and the other in extensions, who winds up one company while the other continues in business.

The examples of 'involved with' basically concern individuals providing e.g. accountancy services following the winding up of their accountancy services

company as an employee of a connected person. The crucial point is that it is not the nature of the trade carried on by the connected person which is relevant but the nature of the services provided by the individual as an employee (not as a trader because that would meet condition C for a different reason).

In most cases, it will be tolerably clear whether condition C is met, which leaves condition D. Condition D is basically a 'main purpose' test. However, the test also relies upon whether it is 'reasonable to assume having regard to all the circumstances' that avoidance of income tax was a main purpose. HMRC consider that the individual will know their purpose and if avoidance was a main purpose they should self-assess on that basis.

Is that 'clear'?

It was decided that section 396B would not be subject to a clearance procedure, on the basis that HMRC do not give clearances on questions of fact. In the example which HMRC give of a builder operating two companies, probably the structure was not adopted for tax avoidance reasons but conditions A-C are met and so the builder would need to rely upon it not being reasonable to assume, etc., that tax avoidance was a main purpose. But there is no 'closure' unless HMRC decide to enquire into his tax return and accept the position (or not).

Ironically, it may be that section 396B might deter phoenixism by individuals who are aiming to avoid tax (because they know who they are) and apply mainly to those who are not. After all, it is a nice bonus to pay CGT at only 10% on winding up so it may be borderline whether that is a subsidiary or main purpose, but this will, of course, depend upon all the circumstances.

Practical Tips:

A change of circumstances within the two years following the distribution might trigger condition C (e.g. a decision to go into partnership in a similar business), in which case condition D becomes crucial in completing the relevant self-assessment return.

This article deals only with ITTOIA 2005, s 396B. However, the 'transactions in securities' legislation (at ITA 2007, Pt 13, Ch 1) should also be considered on a winding-up.