PETE MILLER asks where we now stand with the complex transactions in securities legislation

KEY POINTS

- The basic framework of ITA 2007, s 684.
- Activities that fall within the definition of a ‘transaction in securities’.
- The receipt of ‘relevant consideration’ from certain transactions.
- The exemption where 75% of a shareholding is transferred.
- Calculating the income tax benefit.
- Where to find more guidance from HMRC.

The transactions in securities (TiS) anti-avoidance rules are designed to prevent a range of tax avoidance techniques that broadly seek to turn potential income payments into capital payments, on the basis that the tax charge on capital gains is usually lower than the income tax on a distribution of the same amount.

The rules are very relevant to the small and medium-sized enterprises (SME) market, because they only apply to transactions in securities of close companies (or companies that would be close if they were UK resident): those that are controlled by five or fewer persons or by any number of shareholder-directors.

The rules were changed substantially in FA 2009 [10] and this article looks at the rules as they currently apply.

It is generally accepted that the rules for corporation tax have no application and are probably obsolete, so we are only going to look at the rules for income tax purposes.

Framework

The basic framework of the legislation, in ITA 2007, s 684 [11], is that a person must be party
to one or more transactions in securities within one of the two conditions of ITA 2007, s 685 [12].

The main purpose, or one of the main purposes, of that person in being party to the transactions in securities must be to obtain an income tax advantage.

Not only that, but he must also succeed in doing that.

If a person is caught by this legislation, HMRC are entitled to counteract the tax advantage so obtained.

Counteraction is almost invariably by HMRC issuing an assessment to recover the tax avoided.

However, the legislation (at ITA 2007, s 698 [13]) permits HMRC to counteract a tax advantage by nullifying a right to repayment, by requiring the return of a repayment already made or by the calculation or recalculation of profits or gains or liability to income tax.

A transaction in securities is defined by s 684(2) as ‘a transaction, of whatever description, relating to securities’ and specifically includes:

- the purchase, sale or exchange of securities;
- issuing or securing the issue of new securities;
- applying or subscribing for new securities; and
- altering or securing the alteration of the rights attached to securities.

So the concept of a transaction in securities is very widely defined and it is hard to escape the legislation on the basis that a transaction is not a transaction in securities.

However, decided cases have determined that neither a liquidation of a company nor the payment of a dividend is a transaction in securities (Laird Group plc v CIR 75 TC 399 [14]), so any tax planning that involves only liquidating a company or paying a dividend should not be caught by these rules.

The conditions

The types of transactions in securities to which the rules apply are described in ITA 2007, s 685 [12].

The first is that, as a result of a transaction or transactions in securities, a person receives relevant consideration, without an income tax charge, in connection with the distribution, transfer or realisation of assets of a close company, or in connection with the application of the assets of a close company in discharging liabilities.

‘Relevant consideration’ here means consideration which is or represents the value of assets available for distribution by way of dividend by the company, or assets which would have been so available apart from anything done by the company.

It also includes consideration which is received in respect of future receipts of the company, or is or represents the value of trading stock of the company, although these definitions are of limited practical significance.

An example within this type of transaction would be the sale of a close company to another close company in return for cash.

This would be the realisation of the assets of the company and, if the transferee company has
distributable reserves, then the consideration could represent assets available for distribution.

The vendor would probably pay capital gains tax on the transaction, so the consideration escapes income tax unless HMRC are able to counteract the tax advantage.

The second type of transaction is where relevant consideration is received in connection with the direct or indirect transfer of assets of one close company to another, or the person receives relevant consideration in connection with the transaction or transactions in securities involving one or more close companies and, again, the taxpayer does not pay or bear income tax on the consideration.

For this second type of transaction, ‘relevant consideration’ has a different meaning, being any share capital or security issued by a close company which is or represents the value of assets available for distribution by way of dividend by the company, or would have been so available but for anything done by the company (or are trading stock of the company, but again, this is of limited significance).

An example within this type of transaction would be the sale of a close company to another close company in return for an issue of shares or loan notes.

This would clearly be a transaction in securities involving one or more close companies and, again, if the transferee company has distributable reserves, then the consideration could represent assets available for distribution.

The vendor would probably hope for the transaction to be tax-free under the share-for-share reorganisation provisions (TCGA 1992, s 135[^15]), so the consideration again escapes income tax unless HMRC are able to counteract the tax advantage.

**Fundamental change of ownership**

The transactions in securities legislation cannot apply where 75% of the ordinary share capital of the company changes hands as a result of the transactions in securities ([ITA 2007, s 686][^16]).

The new owner must be somebody who was not connected with the original owner at any time within the two years prior to the transaction, and must also not be connected with them in the two years following the transaction.

However, subject to those conditions being satisfied, this provision gives a complete exclusion from the scope of the legislation, even if tax avoidance is intended.

HMRC’s view is that in cases where 75% of the shareholding was genuinely being transferred to an unconnected party, counteraction would never be required, so this filter will, they hope, materially reduce the number of clearance applications they receive.

However, s 686 is not quite what was hoped for, and there is sufficient uncertainty about its operation that the planned reduction in applications has not yet happened.

One problem area is that [ITA 2007, s 993(7)][^17] tells us that ‘two or more persons acting together to secure or exercise control of [a] company’ are connected with each other.

So, what happens if a person sells 75% of his 100% holding in a close company to someone else, and they then control the company together?

They appear to become connected, following s 993(7), although I do not believe that this was
intended by HMRC (or Parliament).

Nevertheless, this is an area of uncertainty within the legislation.

**Measuring the risk**

The amount of the tax advantage is measured by [ITA 2007, s 687](#). Put simply, it is necessary to compare the tax paid in respect of the actual transaction in securities with the tax that would be paid if a company paid a dividend of the same amount.

However, if the company has not got sufficient reserves to pay such a dividend, the comparison is against the maximum amount that it could pay as a lawful dividend.

As an example, see *Bob’s Share Sale*.

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**Bob's Share Sale**

Bob sells 50% of the shares in his company to a family trust, as part of a tax avoidance scheme, and receives £1m consideration.

He pays capital gains tax of £100,000, because entrepreneurs’ relief is available.

The comparison for the purposes of ITA 2007, s 687 is that, had he received a distribution of £1m, he would have paid income tax of £361,111 (at the top tax rate for dividends). Therefore, there is an income tax advantage of £261,111.

If the company only had distributable reserves of £500,000, the tax on a distribution of that amount would only have been £180,555.

The other £500,000 of consideration is left out of account as the company could not have made a lawful distribution of this amount.

Therefore, in this case, the income tax benefit to Bob is £80,555.

If the company did not have any distributable reserves, no lawful distribution could have been made and there would have been no income tax advantage in this case.

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This shows that there are two benefits to being able to measure the tax advantage. The first is certainty as to one’s tax exposure. It is always important to know how much tax is at stake if one decides to go ahead with the transaction.

There is a second, perhaps more important benefit of being able to measure the tax
advantage: the taxpayer can use the measure to demonstrate that, in comparison with the commercial advantages for carrying out the transaction, the tax advantage is minor.

It is important to recall that the legislation only applies if the main purpose, or one of the main purposes, of the person being party to the transaction in securities, is the obtaining of the tax advantage.

If the tax advantage is small in contrast to the other reasons for carrying out the transaction or transactions, tax cannot have been one of the main reasons for being party to the transactions in securities in the first place.

**Advance clearance**

Under **ITA 2007, s 701** [19], a written application can be made to HMRC for confirmation that the transactions in securities rules will not be applied to a given transaction or series of transactions.

HMRC must then respond to this application within 30 days with a substantive response, either granting or reducing the clearance, or asking for further information.

Where clearance is granted, HMRC cannot apply the transactions in securities rules to the relevant transactions (**ITA 2007, s 702** [20]), so long as they are carried out exactly as described in the clearance letter.

If clearance is refused, there is no appeal, although HMRC will explain why they have refused the clearance and will usually be willing to discuss their concerns, often allowing the transactions to be amended into an acceptable form for which clearance can then be granted.

Unfortunately, there is no formal route of appeal against a refusal of clearance, and the official line is that, if the transactions are carried out, HMRC would normally intend to counteract any tax advantages accruing (see **statement of practice SP 3/1980**).

There is guidance on clearance applications [21] on HMRC’s website. There is also information on the format of clearance applications in **SP 13/1980**, although this statement is about a different form of transaction.

**Conclusions**

The transactions in securities legislation is very widely drawn.

So much so, in fact, that income taxpayers invariably apply for clearance under **ITA 2007, s 701** [19] in conjunction with their application for clearance under other provisions, such as for the application of the reorganisation or reconstruction reliefs (**TCGA 1992, s 135** [15] and **s 136** [22]) or of the ‘exempt distribution relief (**CTA 2010, s 1081** [23]).

And the changes made in FA 2009 do not yet appear to have had the desired effect of reducing the number of clearance applications.

Since taxpayers generally like to have certainty over the tax treatment of their transactions, I suspect that it will be a long time before there is any material reduction in applications for clearance, and certainly this won’t happen until the effect of s 686 is properly clarified.

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