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Why selling a company is not tax avoidance

Misplaced spotlight

Key points

- Proceeds from a winding up of a company are chargeable to capital gains tax unless specific conditions apply, when income tax will be due.
- Spotlight 47 targets schemes that try to avoid the phoenixism TAAR by selling to a third party.
- Taxpayers may prefer to sell a company with undistributed reserves to be sure of the tax treatment.
- How can the GAAR apply to a company that has been sold rather than placed in liquidation?
- The TAAR applied only to transactions involving a company winding up.

HMRC published Spotlight 47 *Attempts to avoid an income tax charge when a company is wound up* on 4 February 2019 (tinyurl.com/y826b6lb). Being a slightly late riser that day – it was, after all, the day after the Super Bowl – I did not see it until I received emails from three people drawing my attention to it.

Having read it, I immediately felt that this was an egregiously misguided attempt by HMRC to scare off taxpayers carrying out entirely lawful transactions. So what is all the fuss about?

Background

Normally, the proceeds of winding up a company will be received by shareholders as a capital gain or an allowable loss for tax purposes. From 1 April 2016, however, such distributions can generate an income tax charge instead if the individual shareholders carry on ‘a trade or activity which is the same as, or similar to, that carried on by the company’ within two years of the receipt of that distribution (ITTOIA 2005, s 396B or s 404A). This was to prevent phoenixing arrangements, whereby a person winds up a company to extract the profits in capital form and continues pretty much the same business in some other form.

The example in HMRC’s *Company Tax Manual* at CTM 36305 illustrates this:

> ‘Mr J is a dance instructor who runs his business through his own company. At the end of each year, instead of paying himself dividend (which would be liable to income tax), Mr J winds up his company and receives the profits as a distribution in a winding up, liable to capital gains tax. He then immediately creates a new company and continues his dance instruction business.
>
> ‘This practice is often known as “phoenixism” (because the new company rises from the ashes of the old).’

The legislation is intended to apply if four conditions are satisfied. The first two are trivial, requiring the company to be a close company and the individual to have at least a 5% interest. The third, condition C, is the phoenixing condition that, within two years of a distribution in the winding up, the individual is carrying on ‘a trade or activity which is the same as, or similar to, that carried on by the company’. Condition D is a motive test because the legislation applies only if the winding up and continuation are designed to avoid income tax.

The Readers’ Forum question ‘Is it a wind up?, (*Taxation*, 6 July 2017) triggered a more detailed article by me, ‘Is this another wind-up’, and a Socratic dialogue between Andrew Hubbard and me, ‘All wound-up’, both in Taxation, 3 August 2017, pages 12 and 15 respectively. The original question was whether this legislation applied if, instead of winding up the company, it was sold. The simple answer is ‘no’ because the legislation refers only to distributions in the winding up of a close company. The article and dialogue also considered whether it went against the intention of parliament or was potentially within the scope of the general anti-abuse rule (GAAR). We concluded, again, the answer to both is ‘no’.

Enter Spotlight 47

We were both surprised, therefore, that Spotlight 47 states: ‘Some scheme promoters claim to have come up with schemes that avoid the income tax charge and get around the targeted anti-avoidance rule (TAAR) legislation. They claim that by making an artificial modification of the arrangements aimed at defeating the intention of the legislation (*by selling the company to a third party rather than winding it up, for example*) the TAAR will not apply. (Emphasis added.)

The spotlight goes on: ‘If it’s claimed that the phoenixism TAAR does not cover the arrangements, HMRC will consider whether the GAAR applies to these schemes.’

Parliament’s intention

At the same time as the draft legislation was published, HMRC issued a so-called consultation document *Company distributions* (tinyurl.com/y4bg65up). ‘So-called’ because this was in reality a lengthy explanation about why it had brought in the new rules as well as some changes to the transactions in securities legislation.

Apart from the phoenixing issue, HMRC also highlighted that some people might choose to accumulate profits in a company before sale because the sale of a company with undistributed profits would normally generate a capital gain – subject to capital gains tax at 20%, or even 10% – rather than be subject to income tax at rates up to 38.1%. However, nothing was done in FA 2016 (or since) about ‘moneyboxing’ despite HMRC’s expressed concerns.

It was evident from reviewing the consultation document and the legislation that parliament intended to apply the new rules only to charge distributions in a winding up to income tax in cases when a company was wound up.

And let us be clear about this, although we talk about the ‘intention of parliament’, it is obvious to all concerned that the only relevant intention here is that of HMRC. In other words, we should be considering what HMRC intended, not parliament, and I think we would all agree that the legislation proves that HMRC was aware of the potential income tax advantage in selling a company with undistributed reserves, but chose to deal with phoenixism in cases only when the company was wound up.

So, whether we consider it to be the intention of parliament under the constitutional fiction or the intention of HMRC, there is an obvious legislative intention that these rules apply only when a close company is wound up, not if it is sold.

Why sell money-box companies?

The Readers' Forum question explicitly asked whether these rules applied when a client had wound up the business of his company and was now intending to sell the cash-box company to a third party. Clearly, if liquidating a company might lead to an income tax charge, but selling it does not, it might be better to sell the company, rather than liquidate it.

Did I then, or do I now, consider this to be tax avoidance? No, I do not. This is within the intention of HMRC or parliament, since the legislation explicitly refers only to the winding up of the company, not to the sale. But let's also look at the other reasons people might now choose to sell the company.

The problem with any legislation with a motive test is that all HMRC sees is that a person has wound up a company, received distributions, but carries on an apparently similar business. It will therefore feel duty bound to open an enquiry to try and ascertain taxpayers' motives to see whether the new rules apply. Dealing with this can be a lengthy process, resulting in emotional stress, as well as the potential high fees. It is small wonder, then, that individuals might grasp at the lifeline by somebody who offers to buy the company so that this legislation cannot be in point. It is safe to say that most cases I have come across when such a sale might have been desirable are those in which the taxpayers concerned were not trying to avoid income tax, they simply wanted to avoid uncertain tax treatment and the possibility of an HMRC enquiry if the company were wound up.

To some extent, HMRC has only itself to blame. The guidance does little to reduce the grey area opened up by the statute and HMRC has no intention of making it any more helpful, on the basis that it does not want to explain to taxpayers how to avoid tax.

Unfortunately, this has two effects. First, the taxpayers cannot be certain that their situation will not be challenged by HMRC because of the uncertainties in the legislation and the fact that HMRC sees only the effect of the transactions and has to enquire into the taxpayer's motives. Second, the guidance is technically for HMRC's staff, so the uncertainties also apply internally and they are, therefore, as much in the dark as everybody else. So this is likely to lead to many enquiries into cases in which taxpayers had no intention of avoiding income tax.

At one end of the spectrum, there will also be people who were genuinely mitigating income tax liabilities by winding up the company and are now circumventing the new rules by selling cash-box companies. But is this tax avoidance? It has been said many times that it is very hard to define tax avoidance. So let's, instead, ask whether selling a company instead of winding it up is something that parliament (or HMRC) did not intend when this legislation was enacted.

On one level, it is an obvious behavioural shift, in particular if there are willing buyers. But, at the risk of repeating myself, HMRC and parliament were aware of the possibility of selling companies with undistributed profits when this legislation was enacted, but chose specifically to pass legislation that applied only to the winding up of a company. It is hard to see how selling the company can be seen as avoidance by any definition, since HMRC may have indicated that it was not keen on it in the consultation document but clearly decided not to act against it.

Does the GAAR apply?

After mentioning the GAAR, the spotlight refers to the 60% user penalty and the possibility that promoters and other facilitators of these schemes might be subject to penalties as enablers. All of these apply only if it is found that the GAAR is applicable in such cases, so let's look at whether it is.

The core of the legislation is in FA 2013, s 207. Tax arrangements are 'abusive' if entering into those arrangements 'cannot reasonably be regarded as a reasonable course of action in relation to the relevant tax provisions, having regard to all the circumstances' (the double-reasonableness test).

Those circumstances include:

- whether the results of the arrangements are consistent with the principles and policy objectives of the tax provisions;
- whether those results are achieved with one or more contrived or abnormal steps; and
- whether the arrangements are intended to exploit shortcomings in the tax provisions.

If we apply this rule to the concept of selling shares in a company with undistributed profits rather than winding it up, I think that, when the legislation imposes either a tax charge or uncertainty on one course of action, to take another equally simple course of action can ‘reasonably be regarded as a reasonable course of action in relation to the relevant tax provisions’. This is especially so when HMRC was clearly aware of the alternative course of action.

Is the sale contrary to the principles or policy objectives of the tax provisions? I answered this earlier – looking at the relevant legislation, ITTOIA explicitly applies only when there are distributions in the winding up of a close company. Lord Hoffmann said that the only place in which you can find the intention of parliament is in the legislation itself (paraphrasing from ‘Tax avoidance’, a lecture in honour of Sir Roy Goode by Lord Hoffmann, reproduced in 2005 British *Tax Review* 197, 202–203) and s 396B is completely unambiguous in this respect.

We can dispense with the second part of the circumstances because I do not consider the sale is a contrived or artificial step. The sale is genuine: the buyer now owns the company and can do what they like with its cash. There is no degree of contrivance or artificiality in such arrangements.

I also do not believe that the arrangements are intended to exploit shortcomings in the tax provisions, because this is not a loophole. The legislation applies only to distributions in the winding up of a close company so to decide to sell the shares instead is surely not something one could describe as exploiting a loophole. This may seem repetitive, but it is vitally important, when HMRC is invoking the possibility of using the GAAR against something so simple, to make it clear why the GAAR should not apply.

More contrived schemes?

It is possible, as hinted at in the spotlight, that there are more contrived or artificial schemes to which the GAAR might apply. But I cannot see how choosing to sell a company rather than winding it up can possibly be seen as being in the same category as contrived or artificial arrangements, circumventing the intention of parliament – or HMRC – or exploiting a loophole. It is clear that parliament (or HMRC) intended the new rules to apply only to distributions in the winding up of a close company and there is no way to read that legislation as inferring that the rules were intended also to apply to the sale of shares of a close company.

It is for this reason that I consider HMRC’s new spotlight to be egregiously misguided. It is explicitly telling us that simply selling a company to a third party, rather than winding it up, is itself ‘an artificial modification of the arrangements aimed at defeating the intention of the legislation’. How could anyone say, even taking the most purposive approach to the legislation, that legislation that refers only to distributions in the winding up of a company could or should apply to a sale of the company.

If that were the intended impact of the legislation, it should say so. Given the importance of the GAAR in HMRC’s armoury, I am astonished it has suggested the GAAR might be applicable.

Why has HMRC done this?

One of the intentions of the spotlights is to try to stop people entering into what HMRC considers to be avoidance arrangements, so there may be an element of deliberate scaremongering here. While I still consider that selling a company in these circumstances is completely acceptable, the spotlight might scare some clients, on the basis that they would prefer to believe HMRC’s deliberate scaremongering to their tax adviser’s more considered and statutorily correct position.

If this is so, it is completely wrong of HMRC. The spotlights should warn taxpayers against avoidance schemes that the department believes do not – or should not – work. They should not be used to dissuade people from entering into arrangements that are within both the letter and the intention of the law. In my view, that is an outrageous abuse by HMRC of its position as the public body in charge of administering the UK’s tax system.

There is also an element of crying wolf here. HMRC cannot invoke the GAAR without, eventually, having to use it, otherwise the threat loses its force. But I cannot for one moment imagine that the GAAR panel would consider that the sale of a company is somehow an unreasonable thing to do or that it would contravene any of the specified circumstances highlighted in the GAAR legislation.

Why not change the law for disposals?

The main reason HMRC did not change the law for disposals is probably that, to the extent that phoenixism was a real problem in some areas, it was usually done by winding up a company and then carrying on the same trade or business through another vehicle. Since this was the abuse HMRC wanted to stop, it chose not to do anything about the sale of a company with undistributed reserves.

There are several conceptual difficulties with trying to decide how much of the proceeds of selling a company should be taxed as income. Readers might think it could be done by saying, to the extent the company has undistributed reserves, that amount of the proceeds of sale should be taxed as income.

But things are never that simple. The company might not be able to pay dividends because it has used its profits to buy assets for its business; the reserves might be technically distributable but the money might be required as working capital for the company.

HMRC may also have stopped short of trying to design a rule about selling the shares of a company because it might be seen as dictating the dividend policy of the company (although that certainly was not an issue when close company apportionment was part of the statutes). Regardless of the reasons, it is clear from the legislation and the consultation document that HMRC made a conscious decision only to attack phoenixing transactions involving the winding up of a company.

Conclusions

I hope that the professional bodies, as well as individual taxpayers, will make their views about Spotlight 47 known to HMRC. There can be no problem with HMRC highlighting genuine avoidance arrangements and trying to persuade taxpayers not to go into them but the way it has gone about Spotlight 47 is an egregious misuse of its administrative powers. Not only is it difficult to think of any circumstances in which anyone could genuinely consider that selling a company is offensive tax planning or avoidance, given the clear intention of the legislation, but the GAAR was enacted for use only in extreme cases. It is inconceivable that HMRC is considering using it for something as straightforward as selling a company, rather than winding it up.

Back to top
Tax Topic Tags: Comment & Analysis [1]

[2] [2]

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