Danse macabre

HEATHER MILLER laments the demise of extra-statutory concession C16.

Nobody likes change, do they? Well, I don't. I think this probably stems from finding out aged 11 on the television evening news that Robbie Williams was leaving Take That; it shook my world to its very core and I can't say that I've ever really got over it. I also get very twitchy after two or three series of *Doctor Who* with no sign of a regeneration, as it's clear that one is looming and who will they choose as the replacement?

So you might say tax is a slightly strange career choice for someone who breaks out in a cold sweat when her local council change the recycling bin collection from Tuesday to Thursday. But the thing is, when changes are made to the UK tax system, whether or not we like the end result, they tend to offer greater certainty for the taxpayers affected. The abolition of extra statutory concession (ESC) C16 on 1 March 2012 to make way for a statutory concession in CTA 2010, s 1030A is certainly meant to be an example of this. It is safe to say, though, that the announcement that ESC C16 was to go to its grave was met with general dismay by tax advisers across the UK.

Misuse

Why was this? Aside from the fact that it seems many more companies will now have to go through the onerous and expensive process of a formal liquidation to receive the preferential capital gains treatment on their distributions, it was the reason given for the change that caused such irritation.

HMRC believe that ESC C16 was being abused, presumably by taxpayers attempting a string of phoenix companies (set up business, make money, strike off under ESC C16 for capital treatment, set up business again in newco, and so on), but did no one point out the obvious?

If the Revenue thought the concession was being abused, perhaps they should have stopped granting it so freely. The clue is in the name: concession. It all seems a bit sledgehammer and nut to me.

KEY POINTS

- Abuse of concession.
- Effect of the £25,000 cap.
- When does intention to dissolve the company arise?
- Micro companies.

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The question is, how many limited companies will become collateral damage on HMRC's quest for clarity?

This article will highlight the effect of this new legislation on the small companies that would have previously benefited from ESC C16. But first, let's recap on the basics of the concession and why it was so useful. ESC C16 stated:

> "A distribution of assets to shareholders by a company which is dissolved under the Companies Act 1985, s 652 or s 652A [later becoming CA 2006, s 1000 and s 1003] is strictly an income distribution within TA 1988 s 209."

> ***"The announcement that extra-statutory concession C16 was to go to its grave was met with general dismay by tax advisers."***

Concession at work

Consider a fictitious example, Tennant Ltd, a family company, which manufactures widgets and is owned by two director shareholders, David and Billie. They started the company from scratch some 15 years ago and it has been successful, but now they want out. They each own a £1 ordinary share in Tennant Ltd and have consistently extracted all of the profits available for distribution by way of a dividend each year.

After the sale of a couple of large pieces of machinery from within the company, they imagined that they would be left with £150,000 of reserves to distribute on a 50/50 basis when the company was dissolved. Assume that Tennant Ltd is David and Billie's only source of income, and that they intended to dissolve the company on 29 February 2012.

INCOME DISTRIBUTION

	David Tennant	*Billie Tennant*	*Tax rate*
Distributable reserves	£75,000	£75,000	0%/25%
Tax			
35,000 x 0%			
40,000 x 25%	(£10,000)	(£10,000)	
Net received	£65,000	£65,000	
Effective tax rate	13.3%		

As ESC C16 states, the default position is that this £150,000 is taxable as an income distribution in the hands of each shareholder, as shown in ***Income distribution***. In this, as in all the examples, the £2 of share capital will be extracted without a tax charge.

In this scenario your best bet would have been to suggest that the directors make good use of ESC C16, so as to create the result shown in ***Capital distribution under ESC C16***. This is to take a pre-cessation dividend up to the basic rate band followed by capital distribution which, subject to the satisfaction of the relevant entrepreneur's relief conditions, would suffer tax at 10% as opposed to 25% on dividends.

> ***"If the company has in excess of £25,000 to distribute as part of the … process, all of the distributions will be classified as dividends."***

Changed position

But if they chose to dissolve their company on say, 31 March 2012, what would be the position under the new legislation? CTA 2010, s 1030A(1) states:

"This section applies where:

(a) the procedure in s 1000 of the Companies Act 2006 (power to strike off an application by company) has been commenced in relation to a company; and
(b) the company intends to make a distribution in respect of share capital in anticipation of its dissolution under that section."

The first thing to note is the absoluteness of the opening line "This section applies …", which, in my head, is followed by "whether you like it or not", but more on this later.

Skipping along to s 1030A(3), (4) and (5) we discover:

"(3) The distribution is not a distribution of a company for the purposes of the Corporation Tax Acts if conditions A and B are met …

"(4) Condition A is that, at the time of distribution, the company:

(a) intends to secure, or has secured, the payment of any sums due to the company; and
(b) intends to satisfy, or has satisfied, any debts or liabilities of the company.

"(5) Condition B is that –

(a) the amount of the distribution; or
(b) … the total amount of the distributions,

do not exceed £25,000."

It was all looking rather good until they swooped in with the £25,000 cap, wasn't it? To be clear, if the company has in excess of £25,000 to distribute as part of the dissolution process, *all* of the distributions will be classified as dividends unless a formal liquidation takes place.

As we know from ***Capital distribution under ESC C16***, the company does have in excess of £25,000 to distribute, which means for the Tennants to benefit from the capital gains tax treatment, they will need to pay for a formal liquidation. This would reduce their overall net distribution by (depending on where you are and who you use) anything from £2,000 plus VAT to, say, £7,000 plus VAT. This does take the shine off the process somewhat.

Intention

As if that were not enough, a glance at s 1030A(2) highlights a somewhat worrying turn of phrase as follows:

"(2) This section also applies where:

(a) a company intends to make, or has made, an application of its dissolution under s 1003 of that Act (striking off on application by company); and
(b) the company makes a distribution in respect of share capital in anticipation of its dissolution under that section."

CAPITAL DISTRIBUTION UNDER ESC C16

	David Tennant	*Billie Tennant*	*Tax rate*
Distributable reserves	£75,000	£75,000	
Split			
Pre-cessation dividend (net)	£31,500	£31,500	0%
Capital distribution under ESC C16	£43,500	£43,500	10%
Tax			
35,000 x 0%			
43,500 – 10,600(AE)			
x 10% =	(£3,290)	(£3,290)	
Net received	£71,710	£71,710	
Effective tax rate	4.6%		

CTA 2010, S 1030A

	Mr Eccleston	*Tax rate*
Distributable reserves	£20,000	10%
Tax		
20,000 – 10,600		
x 10% (assuming entrepreneurs' relief conditions are satisfied)	(£940)	
Net received	£19,060	
Effective tax rate	4.7%	

A company *intends* to make an application: intention is a word that often dominates the more contentious areas of taxation, and its use here seems no different. It appears that HMRC are trying to put a halt to directors paying out dividends to bring their reserves down to less than £25,000, thereby at least benefiting from capital treatment on that amount. But when exactly does the intention to dissolve a company arise? Is it when David and Billie have a huge row one evening and David storms "I can't do this anymore, I want us to get rid of this business"; or when he calls you a week later and asks you for your thoughts on their idea of winding up the company and retiring to Spain?

More importantly, how will HMRC be able to say that the intention was formed at a date other than when a company resolution was made in the minutes? It is clear that some care should be taken in establishing this date; purely to ensure that, if dividends need to be paid, they are paid before the intention officially arises.

All right for some

On that note, it is time to consider a scenario in which the new legislation is useful. Imagine that you have a client, Mr Eccleston who is the sole director shareholder in Eccleston Consultancy Ltd. The business has been going for only three years and has been a reasonably successful sideline for Mr Eccleston, who also has a full-time employment from which he receives a salary of £50,000 a year. He has, however, just been awarded a big promotion which will leave him little time for his consultancy business and so he approaches you with a view to winding up the company and extracting the profits. Eccleston Consultancy Ltd was set up with £1 share capital, and has £20,000 of accumulated distributable reserves on the balance sheet.

In essence, Eccleston Ltd is exactly the kind of "micro company" for which HMRC were more or less forced to increase the original £4,000 cap in their draft legislation to £25,000. Mr Eccleston is in the optimum position that he can apply for Eccleston Consultancy Ltd to be struck off and extract his reserves of £20,000. See ***CTA 2010, s 1030A***.

While we can see that Eccleston Consultancy Ltd's effective rate of tax on the winding up of the company is just a touch greater than Tennant Ltd's effective rate on a similar transaction, the legislation has provided the ability to attain capital gains treatment without a formal liquidation and, crucially, without having to make an application for the treatment as would have been the case under ESC C16.

Overall, it is quicker, easier and cheaper for Mr Eccleston in every way as the five-minute telephone call with the adviser that ends in "yes, the legislation says you can treat it as capital" will certainly be cheaper than the letter the adviser would have drafted and billed him for as regards ESC C16.

Good for liquidators

For a lot of business owners, the situation above may be a bitter pill to swallow. Was it HMRC's intention when drafting this legislation to reward those who operate their business as a sideline while potentially penalising those who have taken the risk of stepping out of employment and going it alone? Perhaps not, but it is at the very least an unfortunate symptom of their attempt at securing certainty for themselves and the taxpayer.

As with any new legislation, there will always be an element of "suck it and see". It may be that the £25,000 capital distribution upper limit will undergo a regeneration of its own and become a higher figure in the coming years; on that we can only speculate. What I think may be more likely, as more directors, companies, and tax advisers attempt to navigate these new rules, is that the only people dancing on the grave of ESC C16 will be the liquidators.

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