

PRACTICE UPDATE

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OFFICE CLOSURE

Please note that the office will be closed between **Monday 15 February and Friday 19 February 2010**.

1. Reducing share capital

The ability of companies to reduce share capital has been simplified following changes introduced in Companies Act 2006 from 1 October 2008.

The capital reduction procedure (in CA 2006, ss 641-657) was discussed in my article 'Don't wind me up' (Taxation, 5 February 2009), in the context of winding up companies using Extra Statutory Concession C16.

As mentioned in that article, a problem with ESC C16 is that it does not involve a formal winding up. Strictly speaking, the company's share capital is 'bona vacantia' and becomes assets of the Crown, Duchy of Lancaster or Duke of Cornwall. However, in practice the Treasury Solicitor will allow share capital up to £4,000 to be repaid without seeking recovery as an unauthorised distribution. A private company with share capital in excess of £4,000 could therefore consider reducing its share capital to within the above limit by applying the capital reduction procedure and meeting certain conditions.

The rules may also be useful in other circumstances, such as repaying share capital that the company no longer wants or needs.

As a result of secondary legislation (Companies (Reduction of Share Capital) Order, SI 2008/1915), the amount of the

share capital reduction is treated as a distributable reserve, which may perhaps be useful if the company's reserves were previously negative.

Pitfalls and limitations

However, it should be noted that the capital reduction procedure only enables the company's share capital to be repaid. It does not allow for receipts in excess of the original subscription cost. A company purchase of own shares may need to be considered in such circumstances. In addition, in a recent *Taxation* article, David Jeffery expressed the view that in certain circumstances a reduction in share capital may constitute a 'transaction in securities' and that a clearance application should therefore be made to HMRC under ITA 2007, s 701.

It should also be noted that a solvency statement must be made by the company's directors as part of the Companies Act 2006 rules. The directors must have reasonable grounds for the opinions expressed in the solvency statement. Otherwise, a criminal offence is committed, which could result in a prison sentence. The whole process should therefore not be taken lightly.

The new procedure is generally helpful, easier and probably less expensive than the alternative solution of applying to the Court to reduce share capital (although some private companies previously

registered as unlimited to allow share capital to be repaid without going through the Court procedure). However, as with most tax and company law issues, careful attention is needed to the procedure.

2. Associated companies

When dealing with small and owner-managed companies, it can often be difficult to ascertain the number of associated companies.

For small companies relief purposes, the lower (£300,000) and upper (£1.5 million) 'relevant maximum amounts' are divided between active associated companies in the accounting period. The small companies' rate of 21% applies to profits up to the lower limit, marginal relief at the effective rate of 29.75% applies to profits between the two limits, and the main corporation tax of 28% applies to profits in excess of the upper limit.

The 'associated companies' rule is essentially an anti-avoidance provision. It is designed to prevent the creation of multiple, closely controlled companies (as part of a wider economic whole) to take advantage of the small companies' rate of corporation tax. The rule therefore establishes who controls a company and thus which companies are associated for small companies' relief purposes.

Current rules

However, the associated company rules for small companies' relief purposes looks set to change. HM Treasury and HMRC propose to change and simplify the rules in the near future. A consultation document was issued in October 2009. The consultation period ended recently.

A major problem with the current rules is that they have a very long reach. They determine control in a very arbitrary way, which does not take into account of commercial reality. In particular, the rights and powers of an associate are automatically attributed to the shareholder for the purpose of determining control (ICTA 1988, s 416(6)).

There are exceptions and relaxations to the rules in certain circumstances. Firstly, under ESC C9, HMRC will not seek to attribute rights held by relatives where there is no substantial commercial interdependence between otherwise associates companies, unless the relative is a husband, wife or minor child. Secondly, the attribution of rights held by associates who are business partners is restricted to situations where 'relevant tax planning arrangements' exist (ICTA 1988, S 13(4)-(4C)).

Unfortunately, these relaxations in the associated companies' rules do not go far enough. In particular, ESC C16 can result in companies being associated even though there is no commercial relationship between them. The proposed new legislation seeks to end this automatic attribution of rights where companies are linked merely by what the consultation document refers to as an "accident of circumstance".

Proposed new rules

Companies controlled by the same person(s), or within a group, will still automatically be treated as associated. However, the proposed new rules provide for the attribution of rights and powers between 'linked' persons in establishing control only if there is sufficient economic, financial or organisational interdependence between them. This change is achieved by a change in the wording of ICTA 1988, s 13. The result is that the attribution rule in s 416(6) would not apply when determining control unless relevant tax planning arrangements have had effect in relation to the taxpayer company. 'Relevant tax planning arrangements' is already defined in the legislation, but the proposed rules widen its scope. The widened term broadly means arrangements to reduce corporation tax by means of small companies' relief.

The changes to the existing legislation are brief. However, the test of whether companies are fragments of a wider

commercial whole requires consideration as to the degree of economic, financial and organisational interdependence between them. To what extent can interdependence exist between companies before the associated companies rules apply? Each case would depend on its own facts. Unfortunately, this means that advisers will be forced to reply on non-statutory HMRC guidance for an indication of their possible approach to a particular case.

The lack of certainty resulting from 'legislation by guidance' will not be ideal. However, the draft HMRC guidance offers some reassurance that the associated companies rule is intended to apply to a real fragmentation of business activities, but not where any association is a mere 'accident of circumstance'. It is estimated that up to 3,000 companies will pay a lower rate of corporation tax as a result of the proposals, which should therefore be welcomed as a positive step forward

3. Regulating tax advisers

HMRC seems determined to adopt a 'policing' role in respect of tax agents. A further HMRC consultation document ('Working with Tax Agents: The Next Stage') was published with the Pre-Budget Report 2009.

There are two main categories of tax agents; those who are affiliated to a professional body, and those who are not. HMRC's first consultation considered the possible registration and regulation of all tax agents, but this idea has not been taken any further.

Reports to professional bodies

HMRC apparently considers that professional bodies can play a part in identifying and addressing poor work by their members. HMRC would seemingly like to develop mechanisms to report agents to their professional bodies in certain circumstances. However, HMRC's preferred approach would initially be to approach tax agents who make honest but repeated mistakes or demonstrate a

lack of technical competence to reduce the issue. A formal report to the professional body may then follow if the issue was not resolved and/or the agent refused to co-operate with HMRC. If the problem persisted, HMRC would consider 'civil remedies' against the agent.

There is some uncertainty over whether HMRC has the legal right to report agents to the professional bodies in the first place. HMRC points out that it already has the statutory power to disclose information to professional bodies about misconduct by its members relating to a function of HMRC (Commissioners for Revenue and Customs Act 2005, s 20(3)).

However, it has been pointed out that reports to professional bodies may cause a breach of confidentiality. Although s 29(3) of the above Act allows HMRC to disclose information to '...a body which has responsibility for the regulation of a profession', the ICAEW, CIOT and others do not regulate their members as such ('Trust in Transparency' by Robert Maas, *Taxation* 14 January 2010).

Non-member agents

HMRC needs a different approach to deal with agents who are not members of a professional body. A financial penalty regime is therefore being considered in those circumstances.

Deliberate wrongdoing

Agents involved in deliberately filing incorrect returns or other wrongdoing face possible criminal proceedings under the proposals. Alternatively, 'civil remedies' would apply. These include wider access to the agent's working papers, a civil penalty regime, and the possibility of 'naming and shaming', i.e. HMRC publishing details of agents found guilty of deliberate wrongdoing.

The consultation document can be downloaded from the HMRC website. The consultation period runs to 3 March 2010. Tax advisers therefore have the opportunity to express their views on what is clearly a very important issue.

4. Tax avoidance schemes

It is no secret that HMRC is taking a tougher line against tax avoidance. Indeed, there is a degree of openness about the type of tax planning arrangements that HMRC regards as unacceptable, or which are not considered to work as intended.

HMRC has an 'Anti-avoidance Group' section on its website, which sets out HMRC's strategy against tax avoidance, (see www.hmrc.gov.uk/avoidance.htm).

In the Spotlight

Part of HMRC's process of informing taxpayers and agents about their approach to certain forms of tax planning is to publish 'spotlights' in part of the above anti-avoidance section of its website. Spotlights are broadly schemes or arrangements which are discouraged on the basis that HMRC is '...likely to challenge' them, and which in HMRC's view '...are not likely to deliver the tax savings advertised'. There are presently seven spotlights:

1. Goodwill - companies acquiring businesses carried on prior to 1 April 2002 by a related party;
2. VAT artificial leasing;
3. Pensions schemes artificial surplus;
4. Contrived employment liabilities and losses;
5. Using trusts and similar entities to reward employees - PAYE and National Insurance contributions (NICs), Corporation Tax and Inheritance Tax;
6. Employer-Financed Retirement Benefits Scheme ('EFRBS');
7. Certain schemes that seek to generate Gift Aid and Gift of Shares tax relief claims.

HMRC publish additional spotlights periodically (Spotlight 7 was added on 6 January 2010), so it is important to check this area of HMRC's website on a regular basis for any updates. Of course, HMRC's technical analysis of spotlighted anti-avoidance schemes is only their view, and

just because HMRC considers an arrangement to be ineffective does not necessarily make it so. However, some schemes (e.g. 1 and 4 above) have subsequently been the subject of legislation to counter them. In addition, it should not be assumed that schemes not included in the list of spotlights are effective or accepted, as HMRC warns that 'A scheme that has not featured in Spotlights may still be challenged.'

Signposts to trouble?

The Anti-Avoidance group section of HMRC's website also lists a number of 'signposts'. These are broadly transactions and arrangements which have been identified as unacceptable in the past. Examples of such transactions or arrangements broadly include those which:

- have little or no economic substance;
- exhibit little or no business, commercial or non-tax driver; or
- involve contrived, artificial, transitory, pre-ordained or commercially unnecessary steps or transactions.

Examples of transactions or arrangements which HMRC considers to display signposts are listed on its website. Whilst it does not automatically follow that tax planning which HMRC treats as high risk will be ineffective, taxpayers and their advisers need to think carefully in advance about the potential implications in terms of additional tax, interest and penalties if HMRC successfully challenges any such scheme or arrangement used.

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