ACTIVE PRACTICE UPDATES

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Heslops

Chartered Accountants

Clipping the wings of phoenix companies

Measures which discourage 'phoenixing' of companies.

Companies can fail for several reasons and, for the most part, these aren't the result of wrongdoing by the directors. For this reason, it's perfectly legal to start a new company after an old one has become insolvent.

However, there are a number of rules that surround carrying on a similar business through a new company after the original company has gone into insolvency.

Known as 'phoenixing', this practice transfers the business, but not the debts, of the insolvent company to a new company.

But what is the problem with phoenixing, and what does the law say about it?

Different tax rates

In some cases, phoenix companies are created as a method of tax avoidance.

When a company is liquidated, the proceeds received by the shareholders are classified as capital distributions and are subject to capital gains tax (CGT).

A basic rate taxpayer pays CGT at 10% on those distributions, while a higher rate taxpayer pays CGT at 20%.

In some cases, the gain may qualify for entrepreneurs' relief, which reduces the rate of CGT to 10%. This could apply when:

- the company has been trading (not just passively investing)
- the shareholder was a director or employee of the company for at least 12 months, ending with the day it ceased to trade
- an individual holds at least 5% of the shares.

In contrast, where the profits generated by the company are withdrawn as salary, the individual pays income tax at rates of 20% to 45%, or 19% to 46% in Scotland, plus 12% or 2% national insurance. Funds paid out as dividends are taxed at 7.5%, 32.5% or 38.1%.

By extracting funds from the company as a capital distribution, the shareholder can save significant amounts of tax.

The problem

Some people run their business through a company and retain as much value as possible within the company until it is wound up.

At that stage, the net assets are distributed to the shareholders, who pay CGT at 10% or 20% on the value they receive.

In order to continue the business, it's reborn in a new company and another liquidation may be initiated after a period of trading.

What does the law say?

Since 6 April 2016, a targeted anti-avoidance rule (TAAR) has applied to capital distributions made from 'close' companies in the process of liquidation.

The TAAR requires a taxpayer to pay income tax, rather than CGT, on the distribution if all of the following conditions are met:

A. The individual receiving the distribution had at least a 5% interest in the company immediately before the winding up.

B. The company was 'close' at any point in the last two years, ending with the start of the winding up.

C. The individual receiving the distribution continues to be involved in the 'same or similar trade or activity' as that of the wound-up company, within two years from the distribution.

D. It is reasonable to assume the main purpose(s) of the winding up is the avoidance or reduction of income tax.

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What kind of business does the law apply to?

The law applies if a person carries on the same or similar business:

- as a partner in a partnership
- as a sole trader
- in a company in which they or someone connected with them holds at least a 5% interest.

What is 'close'?

A close company is controlled by its directors or by five or fewer participators, broadly the shareholders. Most private companies will be 'close'.

The terms of the TAAR also cover companies which are not UK resident, but which would be treated as close if they were resident for tax purposes in the UK.

What is 'same or similar'?

It's difficult to determine exactly what is meant by 'same or similar trade or activity' in condition C.

The term is designed to prevent the argument that a company is not carrying on 'the same' trade because of changes to its business model.

What counts as 'involvement'?

The final part of condition C refers to the individual being involved in carrying on a trade or activity by a connected person.

The word 'involved' is intended to be vague. According to HMRC guidance, the individual will be involved in the new business if they are merely an employee of that business.

However, tax legislation doesn't state that employees who are not also shareholders or directors of the company are 'involved' in the business they work for.

It is unlikely that being a junior employee in a relative's business would constitute involvement.

Motive for winding up

In all cases, the tax-saving motive in condition D must be met for the capital distribution to be caught by the TAAR.

If the taxpayer can show there was no intention to avoid or reduce their income tax bill, the TAAR doesn't bite and the shareholder will pay CGT rather than income tax on the amounts received on liquidation of the company.

Looking ahead

The taxpayer is supposed to self-assess the application of the TAAR on the distribution they receive.

This is difficult to do as they must look forward up to two years after the date of the distribution to forecast whether they will be involved in the same or similar business.

Example 1

Albert is a builder who forms a company to convert a commercial building into residential apartments. All the investors share the risks and rewards, and any losses are contained.

When the new flats are sold the company is wound up and the shareholders, including Albert, receive capital distributions.

Albert repeats this process with another company formed to develop a building plot, as that is the nature of his business.

The TAAR isn't intended to target commercial transactions, as in the case of developers such as Albert. As long as Albert can show there was no tax avoidance motive, the TAAR will not apply.

Example 2

Dorothy is an IT consultant who runs her business through a company.

After trading for 20 years, she winds up her company and starts a new company that offers her services as a recruitment consultant. Some of her clients are businesses she previously dealt with.

Dorothy is still a consultant, but her trade has changed significantly and it's unlikely it would be viewed as the same or similar to that carried on by the wound-up company.

It doesn't matter that she continues to deal with some of the same clients because the nature of the service she's providing is different.

Even if it were argued that her work was similar consultancy support, it is unlikely condition D would be met.

Example 3

Laura worked as a therapist through her personal company, which she wound up in early 2018.

She received the final capital distribution on 25 March 2018. Her personal tax return for the year to 5 April 2018 must be submitted by 31 January 2019, and it can be amended until 31 January 2020.

If Laura were to start a new business, she would have to look forward to 25 March 2020 to check whether her new venture is sufficiently similar to her old therapist business to trigger the TAAR.

If it is, and the other conditions of the TAAR – including the motive test in condition D – are also met, the distribution received in March 2018 will be reconsidered as income and income tax for 2017/18 will be due.

Can I ask HMRC for an opinion?

HMRC will refuse to give an opinion on whether a TAAR will apply to you, because the operation of the TAAR depends on the intentions of the individual taxpayer.

Get in touch to discuss your company.