ER in the context of an MVL

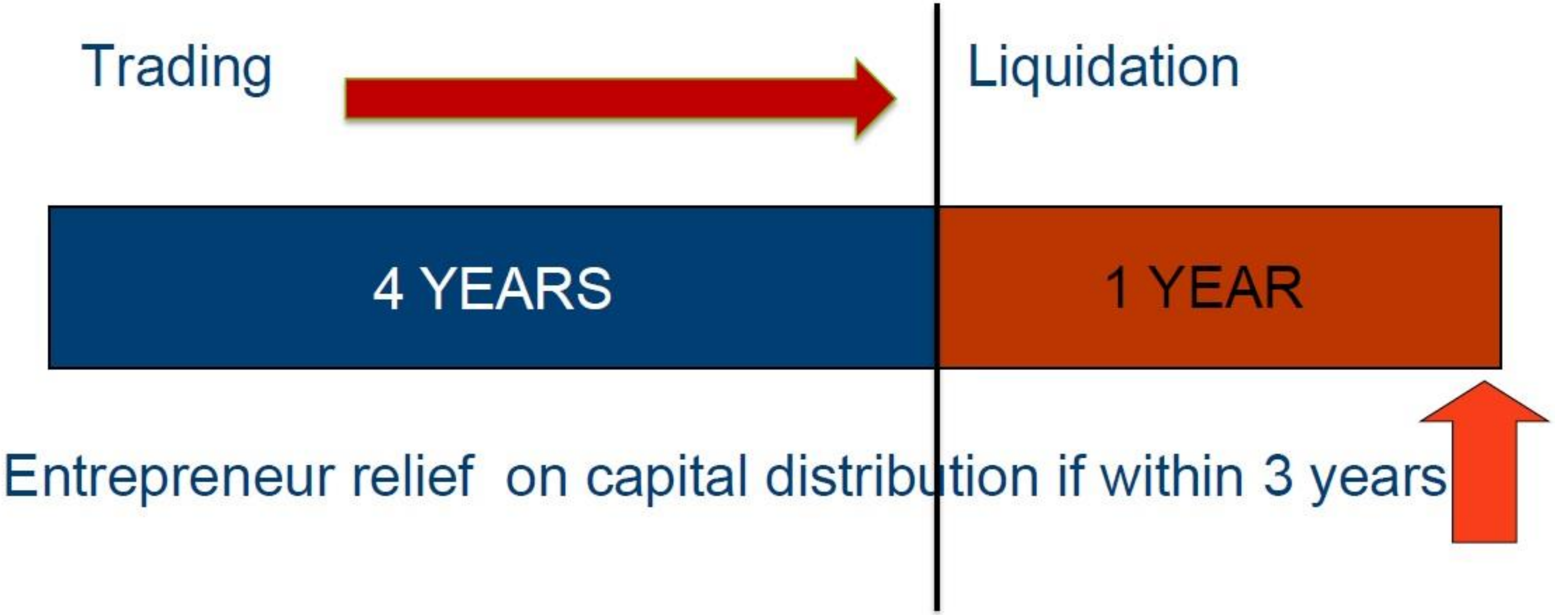
Mark G Mitchell

Running Order

- Changes to ER rules in FA 2019
- The effect of cash balances for ER purposes
- What is more tax efficient – MVL or striking-off?
- The effect of the 2016 liquidation TAAR

Entrepreneurs' Relief Update

- Disposal of shares in or securities of a trading company following cessation of a trade (3 years)



Entrepreneurs' relief changes

- 12 month qualifying period increases to **24 months** from 6 April 2019
- Stricter conditions for personal company from 29th October 2018
- An employee/CO shareholder *entitled* to 5%* or more of:
    - a) Ordinary Share Capital, <u>and</u>
    - b) Voting control, <u>and</u>
    - **c) Distributable profits (alphabet shares an issue)**, <u>and</u>
    - **d) Assets on winding up**

OR

- **e) a) and b) as above <u>but</u> conditions c) and d) disregarded provided shareholder's entitlement to proceeds in the event of a hypothetical sale of the whole company at least 5%**

** 5% nominal value test does not apply to shares acquired under EMI option*

** Election may be made where newly issued shares dilute shareholding below 5%*

Conditions c) & d) – Rights to Profits/Capital

- Shareholder = Equity Holder
- Equity = Ordinary Shares and Non-Commercial Loans
- Ordinary Shares = as defined <u>for CT purposes</u> in CTA 2010, s 160 i.e. differs from the usual s169 definition of OSC at ITA 2009 s989
- Some shares that are OSC under the s989 definition may not be ordinary shares for the purposes of the equity holder condition, and vice versa (e.g. some preference shares)
- Non-Commercial Loans:
  - <u>More</u> than a "reasonable" rate of return
  - Excludes loans where interest is less than or equal to a market rate of return
  - Excludes bank loans

Conditions c) & d) – Rights to Profits/Capital

Normal Limited		
Fixed Assets	60,000	60,000
Cash on Hand	50,000	50,000
Bank Loan	(10,000)	(10,000)
Shareholder Loan ("Normal Commercial Loan")	(99,000)	0
Shareholder Loan ("Not Normal Commercial Loan")	0	(99,000)
	£1,000	**£1,000**
Share Capital	1,000	1,000
Reserves	0	0
	£1,000	**£1,000**
Assets Available for Distribution	1,000	100,000
Available to Shareholder	1,000	1,000
%age Available	100.00%	1.00%
ER available under c) & d)?	Yes	**No**

Condition e) - Hypothetical Sale

- Easier route to determine availability of ER
- Entitlement to proceeds in the event of a hypothetical sale of the whole company at least 5% through ownership of OSC (s989 definition)
- Care should therefore be taken if there are any arrangements in place that change the proportionate interests in the event of an exit
- It assumes that the <u>entire</u> company is sold for its market value on the last day of the qualifying period
- This means that changes to entitlement up to the date of hypothetical sale are ignored
- It also means that minority discounts are ignored for valuation purposes

Condition e) - Hypothetical Sale

Normal Limited			
Proceeds of Sale	**A**	3,000,000	6,000,000
Preferential Rights		(1,000,000)	(1,000,000)
Remainder for OSC Shareholders	**B**	**£2,000,000**	**£5,000,000**
Ordinary Share Capital (OSC) %age for Mark	**C**	**6%**	
Proceeds of Sale Attributable to Mark's OSC	**B*C**	**£120,000**	**£300,000**
Sales Proceeds Entitlement %age	**(B*C)/A**	4.00%	5.00%
ER available under e)?		No	**Yes**

ER and Cash Balances

- Possible loss of ER when balance sheet has cash surplus to working capital requirements?
- s165A(3) TCGA 1992 "Trading company" means a company carrying on trading activities whose <u>activities</u> do not include to a substantial extent activities other than trading activities
- HMRC consider 20% to be substantial
- Merely holding cash is not an activity
- Passively holding investments bought with surplus cash is not an activity
- Consider application for HMRC non-statutory clearance

Strike-Off v Liquidation

- Striking-off procedure under either s1000 or s1003 CA 2006 will be taxed as income distributions <u>if they are in excess of £25k</u> (under the pre 2012 ESC C16 procedure there was no limit)
- MVL = capital distributions (s1030 CTA 2010)
- S/off = Max <u>38.1%</u> DIT v Max <u>20%</u> for MVL
- MVL over £25k always?

MVL v Striking-Off

DS01 Striking-Off (under £25k reserves)		05/04/2020	05/04/2021	05/04/2022	05/04/2023	05/04/2024	
Reserves B/fwd		200,000	162,000	123,500	85,000	46,500	
- Salary		(12,500)					
- Dividends		(24,500)	(37,500)	(37,500)	(37,500)	(21,490)	
- DS01 Distribution		0	0	0	0	(25,000)	
- DSO1 Fees		0	0	0	0	(10)	
- Accounts & Other Fees		(1,000)	(1,000)	(1,000)	(1,000)	0	
Reserves C/fwd		162,000	123,500	85,000	46,500	0	
Cash-in-Hand							
Salary + dividends		37,000	37,500	37,500	37,500	21,490	
S/off Distribution		0	0	0	0	25,000	
Ee's NIC	12.0%	(464)					
Div Tax (after £2k)	7.5%	(1,688)	(2,663)	(2,663)	(2,663)	(1,462)	
CGT (after £12k AEA)(no ER)	20.0%					(2,600)	
Cash in Hand		34,848	34,837	34,837	34,837	42,428	**£181,787**

MVL v Striking-Off

MVL (over £25k reserves)		**05/04/2020**	**05/04/2021**	
Reserves B/fwd		200,000	151,000	
- Salary		(12,500)		
- Dividends		(24,500)	(37,500)	
- MVL Distribution		(12,000)	(109,500)	
- MVL Fees		0	(4,000)	
Reserves C/fwd		151,000	0	
Cash-in-Hand				
Salary + dividends		37,000	37,500	
MVL Distribution		12,000	109,500	
Ee's NIC	12.0%	(464)		
Div Tax (after £2k)	7.5%	(1,688)	(2,663)	
CGT (after £12k AEA)	10.0%	0	(9,750)	
Cash in Hand		46,848	134,587	**£181,435**

MVL v Striking-Off

- Striking-off takes 4 years longer to achieve the same result!
- Ignores other income in those 4 years
- Ignores tax changes in those 4 years
- Dividends <u>must</u> be taken to reduce reserves to the £25k
- If marginal DIT rate was 32.5% then an additional **£37k** DIT through the striking-off procedure!
- MVL preserves the 10% rate unless the liquidation TAAR applied retrospectively

TAAR provisions on MVLs

- Targeted anti-avoidance rule (TAAR) in ITTOIA 2005, s396B
- The aim of the legislation is to counter ‘phoenixism’ – starting a new business soon after winding up a previous one
- Taxpayers are expected to self-assess if the new targeted anti-avoidance rule will result in a liability under s396B
- If Conditions A to C are met you may be caught if Condition D applies

Effect of TAAR

MVL (TAAR applies)		**05/04/2020**	**05/04/2021**	
Reserves B/fwd		200,000	151,000	
- Salary		(12,500)		
- Dividends		(24,500)	(37,500)	
- MVL Distribution		(12,000)	(109,500)	
- MVL Fees		0	(4,000)	
Reserves C/fwd		151,000	0	
Cash-in-Hand				
Salary + dividends		37,000	37,500	
MVL Distribution		12,000	109,500	
Ee's NIC	12.0%	(464)		
Div Tax (after £2k)	7.5%	(1,688)	(2,663)	
Div Tax (TAAR)	32.5%	(3,900)	(35,588)	
Div Tax (TAAR)	38.1%	0	0	
CGT (after £12k AEA)	10.0%	0	0	
Cash in Hand		42,948	108,749	**£151,697**

TAAR provisions on MVLs

- Condition A - 5% OSC and voting rights immediately before winding-up
- Condition B – Close company during winding-up or at any time within two years before the winding-up commences
- Condition C is met where, at any time within the period of two years beginning with the date on which the liquidation distribution in question is made, any one of the four Condition C 'trigger events' occurs
- Condition D is that it is reasonable to assume, having regard to all the circumstances, that—
  - (a) the main purpose or one of the main purposes of the winding up is the avoidance or reduction of a charge to income tax, or
  - (b) the winding up forms part of arrangements the main purpose or one of the main purposes of which is the avoidance or reduction of a charge to income tax

TAAR Condition C

- The four conditions are as follows:
  1. The shareholder receiving the liquidation distribution carries on a trade or activity which is <u>the same as, or similar to</u>, that previously carried on by the company in liquidation; or
  2. The individual is a partner in a partnership which carries on such a trade or activity; or
  3. The individual or a person connected with them is a participator in a company in which they have at least a 5% interest and which at that time in the two-year period under review:
     - (i) carries on such a trade or activity; or
     - (ii) is connected with a company that carries on such a trade or activity; or
  4. The individual is involved with the carrying on of such a trade or activity that is conducted by a person connected with the individual.

TAAR provisions on MVLs

- There is no pre-transactions clearance procedure here
- Even if the intention is not to be involved in future you could be caught
- Proper paperwork proving intentions is vital, however as is
- Proper disclosure in white spaces of SATR needed
- Using TC to conduct the MVL may help to reduce the risk that HM Revenue & Customs will enquire because of our track record

Summary

- It is now necessary to hold shares for two years to get ER
- Cash balances should not affect availability of ER
- Consider application for HMRC non-statutory clearance to manage the risk
- MVL is usually the quickest and safest way to end a company
- Take advice on the application of the TAAR as a minimum
- Use a firm well versed in dealing with the legal and tax consequences of liquidation i.e. Thomson Cooper!

Any Questions?