Ask an expert
Taxing a capital reduction

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A UK resident individual owns 100% of the share capital in a UK holding company, which in turn owns 100% of a UK trading company. This structure arose five years ago after a share for share exchange which was carried out for genuine commercial reasons (with little thought for tax). The trading company was valued at £600,000 at that time and 600,000 £1 shares were issued by the holding company. The individual recently reduced the capital of the holding company by one third, thus receiving £200,000. The funds for this reduction arose from reserves in the trading subsidiary, which were paid up to the holding company as a distribution. What is the tax treatment of the £200,000 payment?

Tax return treatment

Firstly, we need to ask the basic question of whether a legally robust capital reduction should be treated as income or capital in the tax return. This was an issue covered in detail in HMRC guidance issued on 11 February 2013. This points out that capital reductions are excluded from the definition of distributions in CTA 2010 s 1000(1) and concludes that they 'will not be chargeable to income tax', although there may 'be a charge to capital gains tax under TCGA 1992 s 122'.

Therefore, our starting point is that the individual should report his £200,000 receipt in the capital gains section of his return; and, provided we are happy that entrepreneurs' relief conditions are met, any gains would be taxed at 10%. In fact, this is the only correct way to report this transaction.

The transactions in securities (TIS) rules

The above analysis does not, however, give us the whole story. The TIS legislation can give HMRC the ability to counteract any tax advantages that arise when (very broadly) a shareholder receives distributable reserves in a capital form. The legislation is quite complicated and needs to be considered in detail to work out whether it applies.

There is no scope for an individual to self-assess himself to this legislation. However, HMRC has the power to enact the TIS legislation, through the issue of a counteraction notice within six years from the end of the tax year in which any transaction takes place.

The GAAR should not apply, given that a capital reduction 'could reasonably be regarded as a reasonable course of action'. Capital reductions are now a fairly simple and well-trodden path.

Technical analysis of the TIS legislation: Applying the TIS legislation to the above scenario, it is difficult to see how it could apply. This is interesting as this is, prima facie, just the kind of scenario where this legislation is designed to operate.

For the TIS legislation to apply, either condition A or condition B of ITA 2007 s 685 would need to apply. For the purposes of this analysis, please assume that the transaction was entered into for the purposes of securing a tax advantage. (This is a prerequisite for the legislation to operate.)

Condition A: Condition A would be in point if the receipt of the £200,000 constitutes 'relevant consideration'. There are two condition A scenarios which our fact pattern could fall into, and each has a different definition of 'relevant consideration':

- the distribution, transfer or realisation of assets of a close company (s 685(2)(a)); or
- the direct or indirect transfer of assets of one close company to another close company (s 685(2)(c)).

Section 685(4) tells us what 'relevant consideration' is in the context of s 685(2)(a) described above. Here, s 685(4)(a) is relevant to our scenario and this requires the £200,000 receipt to be or represent the value of:

- assets which are available for distribution by way of dividend by the company; or
- assets which would have been so available, apart from anything done by the company.

Before we even consider this, it is worth noting that s 685(6) serves to exclude any assets which 'represent a return of sums paid by subscribers on the issue of securities'. The fact that the shares were not subscribed for in cash (when the share exchange occurred) should not make a difference to this analysis. Case law such as *Irving* [2008] EWCA Civ 6 (where there was no distinction between sums paid and assets contributed) supports this view.

Returning to the definition of 'relevant consideration' (although s 685(6) makes it somewhat irrelevant), it is difficult to see how the cash paid out as part of the reduction could be or represent assets available for distribution. This is for the simple reason that, in both law and in accounting terms, the distributable reserves will be the same both before and after the capital reduction. (Remember it is the capital that is being reduced and not reserves.) The condition A scenario in s 685(2)(a) would fail if this argument holds, but s 685(6) should put it beyond doubt in any event.

Turning to condition A in s 685(2)(c), this should also fail because the definition of 'relevant consideration' for these purposes (set out in s 685(5)) is 'consideration which consists of any share capital or any security issued by a close company'. As the consideration in the current scenario is cash (and not shares), this condition is not met.

Therefore, condition A should not be met, but we still need to consider condition B.

Condition B: Condition B should not be relevant, as it requires that 'two or more close companies are concerned in the transaction or transactions in securities concerned'. Here, it is (arguably) only the parent company which is concerned in the transaction (capital reduction). Anyhow, as for the condition A in s 685(2)(c) above, the consideration would need to be in shares or securities for this condition to apply (which it is not) and therefore condition B should not apply. This conclusion should stand as long as there is no suggestion that the original share for share exchange (which was a transaction in securities) was carried out in contemplation of the capital reduction. If this were the case, then condition B (and therefore the TIS legislation) probably applies.

Clearances

In the author's experience, HMRC is generally (and understandably) reluctant to grant TIS clearances in cases where there is clearly a tax advantage. For example, it would be unusual for HMRC to engage at the clearance stage in the kinds of technical arguments outlined above. Presumably, these would only take place after a counteraction notice has been issued.

Conclusions

This case hopefully demonstrates some of the complexities of the TIS legislation and is an example of where close analysis of the legislation can yield surprising results. This analysis will remain little more than an academic exercise until we see more cases which involve the 'new' TIS legislation. I think that the spirit of the legislation is that it should apply to cases where reserves are extracted in capital form, but I am just not sure that the actual legislation has this effect.

Next week: BEPS and the transfer pricing of management services.