

# FA 2010 analysis

## Transactions in securities

**SPEED READ** The transactions in securities legislation has been substantially amended by FA 2010, with further changes to come. For corporation tax payers, the only change is the repeal of Circumstance A. For income tax payers, the four Circumstances are replaced by a single test that is almost identical in scope to the old Circumstances D and E. And the legislation has a number of negative filters that take taxpayers outside the test: the main purpose test, the close company test, the fundamental change of ownership test and the measure of the income tax advantage.



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**T**he Anti-Avoidance Simplification Review was announced at Budget 2007, to identify anti-avoidance legislation which could be simplified and made more effective without any adverse impact on revenues. The transactions in securities legislation was identified as one area needing review and, following consultation, some changes were enacted in FA 2010.

### Previously ...

The transactions in securities legislation was originally enacted in FA 1960 and has remained largely unchanged until now. The legislation applied more or less identically for corporation tax and income tax purposes. If a person obtained a tax advantage in consequence of one or more transactions in securities in one of the prescribed Circumstances, any tax advantage obtained could be counteracted by HMRC by assessment, withholding of repayment, and the like.

There were originally five specified Circumstances, although Circumstance B was repealed by FA 2008. The other major change since 1960 has been the re-write of the legislation for income tax purposes, as ITA 2007 Part 13, Chapter 1 (from 5 April 2007) and, for corporation tax purposes, as CTA 2010 Part 15 (from 1 April 2010).

The four circumstances which were effective until 24 March 2010 were:

- Circumstance A applies where a person receives an abnormal amount by way of dividend which is used for certain exemptions or reliefs from tax.
- Circumstance C applies where one person receives an abnormal amount by way of dividend and another person receives a tax-free consideration which is or represents the value of assets available for distribution by the company, or is received in respect of future receipts of the company or is or represents the value of trading stock of a company.
- Circumstance D applies where a person receives consideration of the type described

in Circumstance C in connection with the distribution, transfer or realisation of assets of a company under the control of five or fewer persons, or of any other company not listed on the London Stock Exchange.

- Circumstance E applies where a person receives non-taxable consideration in the form of securities, in connection with the transfer of assets of a company under the control of five or fewer persons or not listed on the London Stock Exchange, or a transaction in securities of such a company, where the consideration is or represents the value of assets available for distribution by way of dividend by the company or are trading stock of the company.

In all cases, there was an escape clause whereby, as long as the transactions are carried out for *bona fide* commercial reasons and there is no intention to avoid corporation tax or income tax, as appropriate, then the provisions do not apply.

### The changes

Although the consultation document *Simplifying Transactions in Securities Legislation* (published 31 July 2009) suggested that the changes would be made effective from 1 April 2010 for companies and for the 2010/11 tax years for income tax, in fact, the changes were made effective from 24 March 2010. As a result of these changes, we now have different sets of rules for corporation tax and for income tax, although further work on the corporation tax side is likely to follow in due course.

None of the consultation or current changes were concerned with the administration of this legislation. So the processes for pre-transaction clearance, counteraction and appeals are unchanged and remain the same for both income and corporation tax payers. The changes may not have been effective for companies until 1 April 2010, as CTA 2010 wasn't in force until 1 April 2010. For the last week of March, ICTA 1988 s 704 was still applicable.

### Corporation tax

The proposals were intended to apply to both corporation tax and income tax, although the consultation document also suggested that the legislation might be wholly repealed for corporation tax. The majority of corporation tax changes have been deferred, which is probably a matter of time and resource constraints, so further changes or the total repeal of the rules for corporation tax may follow.

For corporation tax purposes, the only immediate change is the repeal of CTA 2010 s 735, Circumstance A, with effect from 24 March 2010. This is possible because the new corporation tax regime for distributions, in CTA 2009 Part 9A, taxes all distributions received as part of a tax avoidance scheme. Thus any abnormal amounts by way of dividend received by a company with a tax avoidance motive would be taxed anyway and Circumstance A is unnecessary.

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## Income tax

For income tax purposes the changes are far more extensive. The legislation enacted in Finance Act 2010 is more or less identical to the draft legislation published in the original consultation document. In very broad terms, Circumstances A and C are repealed and there is now a single anti-avoidance rule which replicates the old Circumstances D and E.

The discussion document *Simplifying Unallowable Purpose Tests* (published 31 July 2009) proposed a common framework for all such tests and used the proposals for the transactions in securities legislation as a model for the new approach. I have found it quite difficult to fit the new transactions in securities legislation into the framework, but I find it helpful to think of some of the new legislation as comprising filters that are designed to 'refine or reduce the need to consider the test'.

### The unallowable purpose test

The legislation applies to a person, within the scope of UK income tax, who is party to one or more transactions in securities (ITA 2007 s 684(1)(a)). The definition of 'transaction in securities' is moved to ITA 2007 s 684(2) from s 713 but is unchanged. The non-exhaustive list includes the purchase, sale or exchange of securities, issuing or subscribing for new securities and altering or securing the alteration of rights attached to securities.

The unallowable purpose test itself applies if either condition A or condition B is met (ITA 2007 s 685).

The first two legs of condition A are that, as a result of the transaction(s) in securities, the person receives 'relevant consideration' in connection with the distribution, transfer or realisation of assets of a close company or the application of the assets of a close company in the discharge of liabilities. These broadly correspond to the current Circumstance D (ITA 2007 s 689, which is now repealed). In these cases, 'relevant consideration' is or represents the value of assets available for distribution as a dividend by the company, or would have been so available apart from anything done by the company, or the consideration is received in respect of future receipts of the company or is or represents the value of the trading stock of the company, which is very similar to the definition in the old s 689(3). This does not include the return of capital subscribed, even if the legislation under which the company concerned is incorporated would allow such amounts to be distributed.

The last leg of condition A is that the relevant consideration is received in connection with the direct or indirect transfer of the assets of one close company to another. And Condition B requires that the relevant consideration be received in connection with one or more transactions in securities in which two or more close companies are also concerned. These tests broadly correspond to the old Circumstance E.

In both cases, the 'relevant consideration' must consist of share capital or securities issued by a close company, as in the old Circumstance E). The consideration must be or represent the value of assets available for distribution by way of dividend, but

for anything done by the company, or must be or represent the value of assets which are trading stock of the company. If the relevant consideration is non-redeemable share capital, then the provisions would only apply on the repayment of that share capital, whether on a winding-up or otherwise.

### The filters

There are several filters within the new legislation. Indeed, much of the previous section can be interpreted as a series of positive filters, because the legislation applies if and only if the relevant factors are present. In this section, we will consider the negative filters, those factors which, if present, take a person outside the scope of the legislation. As well as being helpful to taxpayers, there is a resource saving for HMRC, as it should no longer have to review so many clearance applications.

- The legislation only applies if 'the main purpose, or one of the main purposes, of the person in being a party to the transaction in securities or any of the transactions in securities, is to obtain an income tax advantage'. This is similar to the old escape clause but without any reference to a commercial purpose. In the consultation response document, HMRC did not consider that a commercial purpose test would 'significantly improve the clarity or simplicity of the legislation.' But it noted that the existence of commercial reasons for carrying out a transaction would help to demonstrate that tax avoidance was not a main purpose of the transactions. While this is clearly a negative filter, it is unlikely to reduce the need to consider the test, any more than the previous version ever has. Taxpayers will continue to want certainty that HMRC is satisfied with the purpose behind the legislation, and it seems unlikely that the number of clearance applications will be reduced by this filter.
- A major simplification is the application only to close companies (or companies that would be close if they were UK resident). This is helpful, as close companies are well understood, so this filter should reduce the number of pre-transaction clearance applications. In particular, most publicly listed companies will now be outside the scope of the legislation, wherever they are listed. One reason for the change is that excepting only companies that were listed on the London Stock Exchange contravened the fundamental freedoms of the EC Treaty. It is interesting, in this context, that the definition of a relevant company for corporation tax purposes has not been changed, so that if there is an unfair and challengeable discrimination, this still exists for corporation tax purposes.
- In the fundamental change of ownership test (ITA 2007 s 686), if 75% of the ordinary share capital of a company (carrying at least 75% of the rights to distributable profits and 75% of the total voting rights in the company) changes hands as a result of the transactions in securities, the legislation does not apply. The person who beneficially owns the shares after the transaction

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must not be connected with the person who sold them and must not have been connected in the two years prior to the transaction (which is a welcome relaxation as the original proposal was that the person acquiring the shares must never have been connected with the person making the disposal). The fundamental change of ownership must continue for at least two years, so that it is not possible to get out of the provisions by an ephemeral change of ownership. This is an empirical test, as HMRC considers that it would almost invariably have given clearance in the past when 75% of the shares of a company were disposed of to an unconnected person. As well as simple sales of companies, this filter may apply to MBOs and secondary buyouts where, typically, the management team hold less than 25% of the shares. They would swap their existing shares for shares in a new company set up by the new venture capitalist owners but would also receive some cash. If the management shareholders are not connected with the new venture capitalist owners, the fundamental change of ownership rule should apply to exclude the buyout from this legislation.

- The new ITA 2007 s 687 explains how to calculate an income tax advantage. But this is not just a computational tool, it is also a negative filter, as the transactions in securities rules only apply if there is an income tax advantage. If, following the computational rules in s 687, there is no income tax advantage, the transactions in securities rules do not apply. The rule requires a comparison of the capital gains tax paid (if any) in respect of the transaction(s) in securities with the income tax that would have been payable by the person potentially obtaining an income tax advantage, if the relevant consideration had been a qualifying distribution by the close company. Any amounts that the close company would have been unable to distribute lawfully are left out of account. This is best illustrated by examples:
  - Bob sells 50% of the shares in his company to a family trust, as part of a tax avoidance scheme, and receives £1m consideration. He pays £100,000 CGT, as entrepreneurs' relief is available. Had he received a distribution of £1m, he would have paid tax of £361,000 (at the top tax rate for dividends). Therefore, there is an income tax advantage of £261,000.
  - If the company had only had distributable reserves of £500,000, the tax on a distribution of that amount would only have been £180,500. The other £500,000 of consideration is left out of account as the company could not have made a lawful distribution of this amount. Therefore, in this case, the income tax benefit to Bob is £80,500.
  - If the company did not have any distributable reserves, no lawful distribution could have been made and there would have been no income tax advantage in this case.

This approach to measuring the tax advantage under these provisions enshrines in legislation what most practitioners had always considered to be the case. However, hitherto, HMRC has always been reluctant to confirm that this is the limit of the extent to which counteraction can be applied. More importantly, we now have a simple computational tool for calculating whether there is a tax advantage, which should reduce the number of pre-transaction clearance applications.

### Summary

To summarise the new rules, the unallowable purpose test at ITA 2007 s 685 has two conditions, A and B, as gateways or positive filters for an unallowable purpose test, and these are almost identical in scope to the old Circumstances D and E. But we also have a number of filters that take taxpayers outside the test: the main purpose test, the close company test, the fundamental change of ownership test and the measure of the income tax advantage.

### Future changes

As already noted, the original intention was for major changes to the rules for corporation tax, or possibly total repeal. And it seems likely that changes will follow in due course.

During the consultation process, there was a lot of comment about the administration of the transactions in securities rules, both for corporation tax and income tax purposes. One area of concern was the convoluted process for counteraction of a tax advantage. This was pointed out by many of the respondents to the original consultation document and HMRC has acknowledged that the process is 'outdated' and promises to follow up on the point.

Also, despite the pleas of a number of respondents, there is no intention to provide a right for taxpayers to appeal to the First-tier Tribunal where HMRC refuses pre-transaction clearance. The reason given is 'the need to balance the increased administrative burdens that would be placed on HMRC, its customers and the Tribunal Service with the perceived benefits'. To my mind, this is a spurious point for three reasons. First, the negative filters, particularly the fundamental change of ownership and the income tax advantage filters, will materially reduce the number of clearance applications HMRC receives. Second, only a very small proportion of clearance applications are refused by HMRC, so it is hard to see how the right of appeal against such a refusal would create a material additional burden to the Tribunal Service. Finally, it is hard to see what increased administrative burden such an appeal facility would put upon HMRC's 'customers', who are the very people who would benefit from such an appeal process.

Overall, though, the changes to the legislation represent a significant simplification of a very complex set of rules, at least for income tax payers, and I hope that this will be carried through into a revised corporation tax regime in due course. ■