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Our ref

Dear

Distributions in a winding up

Thank you for your application for non-statutory clearance concerning a distribution from a winding up.

HMRC do not generally give clearances on "main purpose" tests. This is because at the point of the transaction the main purpose will be known to the taxpayer and cannot always reliably be inferred by HMRC in advance.

Nevertheless HMRC appreciate that difficulties may arise for taxpayers and their advisers in applying the new legislation and are currently working on guidance, which will be published in due course. In the meantime the following may help.

You may have seen the government's consultation on company distributions, which set out, in paragraphs 3.7 – 3.10, concerns about companies being wound up in order to gain a tax advantage. The consultation and the government response is here:
<https://www.gov.uk/government/consultations/company-distributions>.

The new legislation is designed to focus on the situation where shareholders are using winding up procedures as a means of distributing company profits, rather than paying dividends, so receiving the profits taxed as capital rather than income. The legislation applies only where all four conditions are met. HMRC expect the vast majority of distributions in a winding up will remain to be treated as capital receipts.

Conditions A and B are relatively straightforward; the company being wound up must be a close company (or have been a close within two years prior to the winding up commencing) and the individual must have held at least a 5% interest in the company (ordinary share capital and voting rights).

Condition C is that the individual continues to carry on the same or a similar trade or activity to that carried on by the wound-up company within the two years following the distribution. Trade or activity is not defined, and is therefore to be interpreted widely as anything done by the company. Condition C goes on to set out the way in which the individual would be viewed as continuing the trade or activity. It will include as a sole trader, through a partnership, through another company, and through connection to the company of an associate. Any connection to the same or a similar activity will suffice which will include, for example, working as an employee for a spouse in a similar trade. Condition C will not be met where the individual is employed by an unconnected third party.

Condition D is that “it is reasonable to assume, having regard to all of the circumstances” that there is a main purpose of obtaining a tax advantage. The circumstances in particular include that condition C is met. HMRC’s view is that Condition C is widely drawn but Condition D narrows the application to circumstances where, when considered as a whole, the arrangements appear to have a tax advantage as one of the main purposes. Some examples follow which meet conditions A to C, in order to demonstrate the operation of condition D.

Example 1

Mr A has been the sole shareholder of a company which carries on the trade of landscape gardening for ten years. Mr A decides to wind up the business and retire. Because he no longer needs a company he liquidates the company and receives a distribution in a winding up. To subsidise his pension, Mr A continues to do a small amount of gardening in his local village.

Conditions A to C are met, because gardening is a similar trade or activity to landscape gardening. However, when viewed as a whole, these arrangements do not appear to have tax as a main purpose. It is natural for Mr A to have wound up his company because it is no longer needed once the trade has ceased. Although Mr A continues to do some gardening, there is no reason why he would need a company for this, and it does not seem that he set the company up, wound it up and then continued a trade all with a view to receive the profits as capital rather than income. In these circumstances, Mr A’s distribution in the winding up will continue to be treated as capital.

Example 2

Mrs B is an IT contractor. Whenever she receives a new contract, she sets up a limited company to carry out that contract. When the work is completed and the client has paid, Mrs B winds up the company and receives the profits as capital.

Again, conditions A to C are met because Mrs B has a new company which carries on the same or a similar trade to the previously wound up company. Here, though, it looks like there is a main purpose of obtaining a tax advantage. All of the contracts could have been operated through the same company, and apart from the tax savings it would seem that would have been the most sensible option for Mrs B. Where the distribution from the winding up is made on or after 6 April 2016, in these circumstances the distribution will be treated as a dividend and subject to income tax.

Example 3

Mrs C is an accountant who has operated through a limited company for three years. She decides that the risk involved with running her own business is not worth her effort, and so decides to accept a job at her brother’s accountancy firm as an employee. Her brother’s firm has been operating for eight years. Mrs C winds up her company and begins life as an employee.

Conditions A to C are met because Mrs C is continuing a similar activity to the trade that was carried on by the company. She is continuing it as an employee of a connected party, triggering Condition C. But looking at the arrangements as a whole it is not reasonable to assume that they have tax advantage as a main purpose, so Condition D will not be met. Mrs C’s company was incorporated and wound up for commercial, not tax, reasons; although she works for a connected party it is clear that the other business was not set up to

facilitate a tax advantage because it has been operating for some time. In these circumstances, the distribution from the winding up will continue to be treated as capital, absent any other considerations.

The above explanation and examples should provide some clarity until guidance on the new legislation is published on HMRC's website. I expect that to happen within the next few months.

Yours sincerely