Value shifting and pre-sale dividends

Mike Lane, Partner

The simplification review process on chargeable gains rules for companies has resulted in significant progress for which both HMRC and HM Treasury deserve much credit. In the main they have listened to businesses’ gripes over the complexity of the degrouping charge, the pre-entry loss rules and the value shifting provisions, and have responded helpfully. However, the approach taken by the new value shifting legislation to pre-sale dividends will give taxpayers and their advisers some difficult issues to grapple with.

It has long been accepted that the payment of a pre-sale dividend in order to avoid double taxation should not be the subject of counteraction. That is to say that if a parent company’s shares in a subsidiary are standing at a gain which represents profits earned by, and taxed in the hands of, the subsidiary, a pre-sale dividend can be paid to reduce the value of the subsidiary and avoid the same economic profit being taxed again on the sale (absent the application of the substantial shareholdings exemption).

Under the current legislation that is achieved by TCGA 1992 s 31 which provides for a reduction in value attributable to the payment of an intra-group dividend to be left out of account for the purposes of TCGA 1992 s 30 except to the extent that it is sourced from “chargeable profits”. Broadly speaking, chargeable profits are profits arising on a no gain/no loss disposal of an asset, on an exchange of shares or debentures falling within the reorganisation provisions or on the accounting revaluation of an asset. A group can therefore have certainty that a pre-sale dividend cannot be counteracted under the value shifting legislation by ensuring that it is not paid out of chargeable profits.

The consultation process began with a proposal to move away from the chargeable profits concept to a purpose test for companies disposing of shares or securities in the interests of simplifying the existing rules. There is no doubt that the existing rules are somewhat complex. However, one assumes it cannot also have escaped HMRC’s attention that the definition of chargeable profits is rather rigid and out of date. It would be very difficult to maintain an exhaustive list of all of the ways in which a company might generate distributable profits otherwise than through earning taxable profits and a move to a purpose test would also address that.

Finance Bill 2011 Sch 9 para 2 proposes the replacement of TCGA 1992 ss 31 to 34 with a new TCGA 1992 s 31 which sets out three conditions which must be satisfied before a value shifting adjustment is to be made when one company disposes of shares or securities in another company. An adjustment is to be made if:

(a) arrangements have been made whereby the value of the shares or securities disposed of, or any asset owned by a member of the same group as the disponor, is materially reduced;

(b) the main purpose, or one of the main purposes, of the arrangements is to obtain a tax advantage; and
(c) the arrangements do not consist solely of the making of an exempt distribution.

“Tax advantage” here means only the avoidance of a liability to corporation tax in respect of chargeable gains and an exempt distribution is one falling within CTA 2009 s 931H, the “sweeper” provision which itself incorporates a purpose test, or which would fall within CTA 2009 s 931H but for the recipient being a small company.

There can be no doubt that the third condition is intended to be helpful. When the original consultation document was published in February 2010 the draft legislation only contained the first two conditions. The December 2010 response document noted that many respondents felt that, as originally drafted, the new rule would catch pre-sale dividends and the third condition was being introduced in response. But how does one interpret it?

Taking the legislation at face value, it is difficult to see when value shifting arrangements would ever consist “solely” of an exempt distribution. Unless the relevant company keeps physical cash at hand, the simplest pre-sale dividend will invariably involve at least the payment of the dividend itself and a loan relationships related transaction consisting of either the repayment of an existing debt, where the company has the cash but it is on deposit with its bank or a group treasury company, or the creation of a new debt, where it borrows the necessary funds.

When draft guidance on new TCGA 1992 s 31 was first published on HMRC’s website it contained two examples which neatly illustrated the difficulty here. In Example 1 a target company with a large cash balance paid a pre-sale dividend. The guidance stated that “the only arrangement here that could be considered as tax motivated is the payment of a dividend” and so the third condition was not met. This contrasted with Example 5 where the target company had distributable reserves but no cash and had to borrow to fund the dividend. Here we were told that the arrangements did not consist solely of an exempt dividend, because of the borrowing, and a value shifting adjustment would be made. So two examples, each seemingly with an arrangement involving the payment of a dividend and a loan relationships related transaction, one of which we are told consists solely of the payment of an exempt dividend and one of which does not. Example 5 also called into question whether there had been a change of policy in this area. Under current law it does not matter how the pre-sale dividend has been funded and it is considered perfectly acceptable to borrow to fund a pre-sale dividend to avoid double taxation (cash representing the taxed profits might not yet have been received or might have been reinvested in the business, for example).

The draft guidance was reissued in April 2011 with some changes which make HMRC’s views more discernible. In Example 1 the exempt dividend is no longer considered tax motivated. In Example 5 we are now told that the distributable reserves are distributable “profit” reserves (it is difficult to see what this adds, at least in relation to a company governed by the Companies Act 2006, which can only ever make distributions out of “distributable profits”) and that the company borrowing to pay the pre-sale dividend now passes the purpose test (on seemingly the same fact pattern on which it failed the purpose test in the previous cut of the guidance). No counteraction is required because “the payment of existing distributable reserves before the sale of a company is normal commercial practice and so is not regarded as being tax motivated”. No doubt those groups who have found themselves undergeared in the United Kingdom and who have looked to match their funding profiles to those of their competitors, clearly also “normal commercial practice”, only to find they are denied arbitrage clearances on the basis of purpose and who face difficulties in relation to CTA 2009 s 441 will allow themselves a wry smile at such a statement.

To put it another way, it appears HMRC are taking the view that what might be considered a “normal” pre-sale dividend does not fail the new purpose test. And that is why the third condition was omitted from the original drafting. On that view of the world such a condition would be unnecessary.
The author finds that view very difficult to square against the legislation. Is a group which actually falls within Example 5 really going to feel comfortable relying on the guidance when they seem clearly caught by the legislation? If a target company borrows money to pay up a dividend for the sole purpose of eliminating the chargeable gain which would otherwise arise to its parent on sale, all three conditions would appear to be met. The only purpose of the value shifting arrangements is the very one prescribed by the legislation and those arrangements consist of more than just the payment of the dividend. Yet the group, which knows that that is the only purpose of the arrangements it has put in place and may well have recorded that in board minutes and other documentation, is expected to rely on guidance telling it that that is not one of the main purposes of its arrangements. Following the decisions in Wilkinson v CIR [2006] STC 270 and Hanover Company Services Ltd [2010] UKFTT 256 (TC) that is not a particularly happy place to be in and is going to give any tax adviser asked to opine on such arrangements and on the enforceability of such guidance real pause for thought.

In an ideal world, the legislation would be tweaked so that the third condition were not whether the arrangements consisted solely of the payment of an exempt distribution but, rather, whether the reduction in value were attributable solely to the payment of an exempt distribution. Given that the definition of “exempt distribution” should already operate to separate the sheep from the goats in terms of dividends with “good” and “bad” sources by reference to CTA 2009 s 931H it is difficult to see when any reduction in value which is attributable to an intra-group dividend which is an exempt distribution should be counteracted as a matter of principle.

However, with the consultation period closed and the Finance Bill published, such a change now looks increasingly unlikely. The best taxpayers can realistically hope for is further clarification in guidance on HMRC’s view of when the purpose test is not met. Whither Walton J’s famous conclusion in Vestey v IRC [1977] STC 414 “One should be taxed by law, and not be untaxed by concession”?

This article was originally produced for the 23 May 2011 edition of Tax Journal.