Ignorance or apathy?

PHILIP RIDGWAY shows how a lack of joined-up thinking has led to inconsistent treatment of the sale of goodwill.

William E Simon, the Secretary of the US Treasury during the Nixon administration, said "the nation should have a tax system that looks like someone designed it on purpose". Perhaps the UK government took this on board when it altered entrepreneurs' relief on incorporation restricting it on the sale of goodwill because it gave an "unintended advantage" to those incorporating a business.

Some have called the action intellectual dishonesty, but I prefer to call it revenue raising – after all, this unintended advantage has been around for a long time. But to give the government the benefit of the doubt, does this mean it will set about removing other unintentional advantages or, better still, unintentional disadvantages from the tax system?

With a view to helping the government with its new found quest for fairness, in this article I am going to look at six fictitious companies. They are all different, but not so that they warrant materially differing tax treatment and are thus ripe for the government's eradication of unintended advantages policy.

Old goodwill

The first three are Steady Ltd, Slumber Ltd and Sloth Ltd. Each is a successful family owned and run engineering company incorporated in the 1950s. Their goodwill is therefore "old goodwill" and in the capital gains tax regime.

Steady has regularly taken advice from its tax adviser and, although it has never indulged in what might be termed aggressive tax avoidance, it has kept up to date with legislation. It used to have three separate trades operating through three divisions. Three or four years ago, believing that one day it might sell one or more of its trades, the business incorporated three subsidiaries on the advice of the tax adviser and hived down each of the trades to a separate new subsidiary. It was anticipated that, as a result, a sale of any of the three subsidiaries would benefit from substantial shareholdings exemption (SSE). The trades' goodwill transferred down to each of the subsidiaries at the original nil base cost under TCGA 1992, s 171.

Slumber occasionally takes advice from its tax advisers but rarely acts on it. Believing the advice to consist of scaremongering, Slumber resents paying what it regards as high fees. Like Steady, it operates through three divisions and was advised to transfer the divisions to subsidiaries a couple of years ago, but never did this.

Slumber has recently disposed of a dormant subsidiary on the basis the compliance cost of keeping it was greater than the cheap liquidation it was offered by a liquidator one of the family met at the golf club.

Sloth, too, operates through three divisions. It has a dormant subsidiary because, despite advice, it has never made the decision to get rid of it.

New goodwill

The other three companies are Easy Ltd, Whizzy Ltd and Wise Ltd. Each is owned and run by computer science graduates from the local university and all were incorporated in 2004. Their goodwill is therefore "new goodwill" and the tax treatment is governed by the intangible fixed assets regime. Any profit on disposal will be taxable as income not capital. All operate in the "high tech new economy" developing state of the art software for computer games.

Easy operates through three divisions, each developing a different type of software. It has occasionally taken tax advice but feels that, as part of the new economy, accountants in suits do not fit in with its image as "cutting edge". It is the future and so has nothing to worry about.

Whizzy too has three divisions, each developing a different type of software. It took advice when it was founded and set up three subsidiaries but things moved so fast that they have never used them and, as a consequence, have been dormant since.

KEY POINTS

- The government's policy of attacking unintended advantages.
- Treatment of sale of shares in a subsidiary company.
- Is the disposal subject to capital gains tax or corporation tax?
- Seemingly identical companies will be treated differently according to whether they began business before or after April 2002.

Wise took advice when it was founded and set up three subsidiaries, each carrying on one trade developing software. The structure was set up on the basis that, if someone wanted to acquire one of the trades or divisions, it might receive the SSE on the sale of the relevant subsidiary. Wise considered that its tax advisers were perhaps generating fees from the creation of three subsidiaries and the compliance costs of running them, but considered that it was paying for professional advice which it should take and accept.

Coincidentally, all six businesses have received offers from a third party to acquire one of their trades. Each has the same base cost in the trade concerned and was offered the same price initially. All are minded to accept the offer, but want to understand the tax consequences and so contact their tax advisers.

Old regime issues

Steady is feeling smug. Having, four years ago, transferred the trades under TCGA 1992, s 171, it has been told that a sale of the shares in its subsidiary will result in a disposal that will qualify for SSE. What is more, the disposal will result in s 179 applying. Therefore, the subsidiary will be treated as disposing of and reacquiring the assets which were transferred to it four years ago at their then market value.

Although this will result in a gain, it will be added to Steady's disposal proceeds and so will be subject to the SSE. The whole gain will therefore be tax free and the subsidiary will have rebased its assets to the value four years ago, the time of the original transfer.

Slumber is feeling glum. It is still trading through three divisions. If it disposes of a division to the buyer it will make a gain on which it will have to pay corporation tax. It may be able to claim roll-over relief but the group has neither bought nor intends to buy any capital assets that would qualify.

It looked at the possibility of transferring a division to a new subsidiary (Newsub) because it had heard that legislation had been introduced in FA 2011 to create a "level playing field" between companies that operated through divisions and those that operated through subsidiaries.

Substantial shareholding

The legislation in TCGA 1992, Sch 7AC para 15A allows the period for which the investing company (Slumber) is treated as holding a substantial shareholding in the company invested in (Newsub) to be extended if four conditions are satisfied.

The first is that immediately before the disposal of Newsub, Slumber holds a substantial shareholding in it. This would be satisfied because Slumber would have a 100% shareholding in Newsub and the SSE requires only 10%.

The second is that an asset (the goodwill) which, at the time of the disposal of Newsub, is being used for the purposes of a trade carried on by Newsub, was transferred to it by Slumber. Transferring the goodwill as part of the hive down of the trade would satisfy the condition.

The third is that, at the time of the transfer of the goodwill, Newsub and Slumber were members of the same group. This condition would be satisfied because, provided the hive down was effected before the sale was agreed with the third party, Slumber and Newsub would be the two group members.

The fourth condition is that the goodwill was previously used by a member of the group (Slumber) other than Newsub for the purposes of a trade carried on by Slumber when it was a member. This condition would not be satisfied. Slumber disposed of its dormant subsidiary a couple of years ago, afterwards operating as a singleton company with three divisions.

If it were to drop the trade down today it would have to wait a year until it could sell the shares in Newsub before being eligible for the SSE on the sale. It is sure that it disposed of the dormant subsidiary on the advice of its accountant who has now reminded Slumber about the conversation in the golf club with the local liquidator.

"If it disposes of a division to the buyer it will make a gain on which it will have to pay corporation tax."

It therefore appears that it has to sell the division and pay corporation tax on the sale. It might be able to agree a higher price because the goodwill will become new goodwill in the hands of the purchaser who will be able amortise it for tax purposes. However the increase in price, which will itself be taxable, will not come close to the amount it has to pay on the disposal.

Sloth is overjoyed. It seems that doing nothing has its benefits. It has been advised that if it transfers the target trade to a new subsidiary, it will be able to sell the shares in the new operation to the third party tax-free under the SSE. The transfer the trade will be for no gain/no loss under s 171 and, on the sale, the new subsidiary will be deemed to dispose of and require the assets, including the goodwill, at today's market value. The gain will be added to Sloth's sale proceeds and be exempt under the SSE.

This is because, under para 15A, the holding period of the subsidiary's shares will be extended by the period that the assets were used by Sloth while it was a member of a group, which it was because it did not dispose of its dormant subsidiary. Sloth could hive down the assets to its dormant subsidiary and sell that but has been advised that it would be better to incorporate a "clean" company.

In any event, if it did hive down to the dormant company and sell it, it would then be in the same position as Slumber having two divisions and not a member of a group. Keeping the dormant company would allow Sloth to hive down one of the remaining divisions and obtain the SSE on that sale too.

New regime issues

Easy is not happy. It has been advised to sell its division to the third party and pay corporation tax on any profit. It may get a higher price because the purchaser can amortise the goodwill it acquires for tax purposes, but this will not make up for the tax it has to pay. Easy feels that, not only is it expected to be the great

hope for the UK economy in providing jobs, but it is now also expected to contribute more to reducing the economy's deficit.

Whizzy is also not happy. It could sell the division directly to the third party and pay corporation tax on the sale. It could also hive down the division to one of the three dormant subsidiaries and sell that.

Although it set up and retains the three dormant subsidiaries, its goodwill is in the intangible fixed asset regime. Consequently, any hive down of the division to one of the three subsidiaries will not be a no gain/no loss transfer governed by TCGA 1992, s 171 but would be a tax-neutral transfer governed by CTA 2009, s 775, which in effect will amount to the same thing.

When the subsidiary is sold to the third party, the subsidiary will be deemed to dispose of and reacquire the goodwill at market value under CTA 2009, s 780. Section 780, being the intangibles equivalent to TCGA 1992, s 179, deems a tax charge to arise in the company being disposed of and does not visit it on the business disposing of the shares. It is possible to roll the gain into another group company, in this case Whizzy, under CTA 2009, s 792.

But that will depend on Whizzy having sufficient capacity and only defers the gain, it does not eliminate it. Whizzy will therefore be selling a company with a latent tax charge resulting in any purchaser being likely to reduce the price offered for the shares. It will, though, be entitled to the SSE on the disposal of the shares.

Whizzy will have two choices: a taxable disposal of the assets at a potentially increased value because the purchaser will be able to amortise the cost of the assets; or a non-taxable disposal of the shares in a subsidiary of potentially decreased value because the purchaser will be buying the subsidiary with a latent tax charge and will not be able to amortise the value of the goodwill.

Although the intangible fixed asset legislation in many ways mirrored the capital gains tax legislation on which it was based, changes in 2011 to TCGA 1992, s 179 were not replicated in the intangibles fixed asset legislation. This has led to a difference in treatment between what can be identical companies depending on whether they started business before or after 2002.

Wise is very happy with its position. It has no need to transfer anything to a subsidiary. The trade which it is selling has grown in the subsidiary and it will benefit from the SSE on the sale of the shares for the full value of the business.

The same but different

The conclusion to be drawn is that our tax system treats six companies differently even though economically they are in similar positions. This is because of something as trivial as whether they have a dormant subsidiary or something as fundamental as the government having lost sight of the basis on which the legislation was introduced.

So do we have a tax system that looks like it was designed on purpose? ■

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