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Enactment of HMRC’s Extra-Statutory Concession C16

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HM Revenue & Customs (HMRC) has limited discretion to make concessions in relation to statutory tax provisions. Following a recent judicial decision suggesting that this discretion was more limited than had been assumed previously, it has embarked on a programme of enacting many of these concessions. One such is a concession benefiting shareholders of dissolved small solvent companies, which has recently been enacted in modified form and will come into effect on 1 March 2012.

ESC C16 was enacted on 31 January 2012 when The Enactment of Extra-Statutory Concessions Order 2012 received Parliamentary approval. Until now, ESC C16 has allowed shareholders of those companies dissolved without having had a liquidator appointed to treat any distribution of surplus assets as capital payments rather than income. The new statutory provisions will now require such distributions that exceed £25,000 to be taxed as dividends.

In a formal winding up, distributions to shareholders are treated as capital payments rather than income, which is otherwise the norm. ESC C16 equalised the tax treatment of a distribution made outside the winding up process by a small company facing disproportionate winding up costs. Small companies with surplus assets may be dissolved for a number of reasons. From a tax perspective, however, the goal of shareholders is always going to be the same, irrespective of the circumstances behind a company’s dissolution: they will be looking for a tax efficient way to end their investment in the company.

Following a public consultation, HMRC raised from £4,000 to £25,000 the proposed ceiling for the treatment of total distributions as capital payments. This increase was in response to comments that £4,000 was too low to be of use to small businesses. While HMRC views the £25,000 ceiling as an inbuilt protection against tax avoidance, the fact remains that the use of a ceiling is a clear departure from ESC C16, which imposed no limit and had similar safeguards to those included in the newly enacted provisions. These safeguards include the requirement that the company is intending to secure, or has secured, the payment of sums due to it, and intends to satisfy, or has satisfied, its debts or liabilities.

If total distributions do not exceed £25,000 (other than amounts representing repayment of share capital), there will be no change from the position under ESC C16. But if total distributions exceed £25,000, all distributions will be taxed as dividends. While this will be advantageous for a basic rate taxpayer (with an effective tax rate of 0 per cent on dividends), in most cases it will be detrimental to higher and additional rate taxpayers. Provided Entrepreneurs’ Relief is available, a higher rate taxpayer will face an effective tax rate of 25 per cent on dividends as against a 28 per cent—or, with Entrepreneurs’ Relief, 10 per cent—tax rate on capital gains. An additional rate taxpayer will face an effective tax rate of 36.11 per cent on dividends as against a capital gains rate of 28 per cent or 10 per cent.

It should also be noted that the new statutory provisions will apply to dissolutions of companies incorporated outside the United Kingdom as well as to UK companies (as did the concession). They will apply where a shareholder of such a company, which is informally dissolved under corresponding local law, is liable to UK tax in respect of distributions received or capital gains in respect of his/her shareholding in the company.

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