

Part 1: Close companies

Overview

1. This Part rewrites sections 414 to 417 and 419 to 422 of ICTA and Schedule 12 to FA 1989, which are concerned with close companies.
2. A company controlled by a small group of persons may arrange its affairs to enable those persons to avoid income tax. The close company provisions in Part 11 of ICTA counter this.
3. The close company legislation, as such, has two main effects. First, section 418 of ICTA extends the meaning of “distribution” to encompass certain benefits which may be disguised distributions of profit to the shareholders or their families. Section 418 is being rewritten in Bill 6 as part of the legislation on distributions. See clause 69[j5418] under CC/SC (08) 23. Second, section 419 of ICTA imposes tax in respect of certain loans made to shareholders or their families which could in practice represent the extraction of profits without the payment of tax by those persons. Section 419 is rewritten in Chapter 3 of this Part of the Bill.
4. Other legislation imposes further restrictions on close companies. For example, close companies which are “close investment-holding companies” (as defined in section 13A of ICTA) are not entitled to claim to pay the rate of corporation tax for small companies. Section 13A is being rewritten in this Bill as part of the legislation on relief for small companies. See CC/SC (08) 03.
5. The term “control” is defined for close company purposes in section 416 of ICTA. This definition is also widely used in other contexts. Section 416 is rewritten in Chapter 2 of this Part of the Bill.

Chapter 1: Overview of Part

Clause 1: Overview of Part

6. This clause introduces the Part. It is new.
7. In its present form, the close company legislation in Part 11 of ICTA largely dates back to 1965. The opportunity has been taken to disentangle its structure.
8. The definitions of some key technical terms are located near the beginning of the Part, in Chapter 2.
9. Chapter 3 imposes the charge to tax in connection with loans or advances by close companies to participators.
10. Chapter 4 contains a power to obtain information in connection with close companies.

Q1. We welcome comments on the structure of this Part.

Chapter 2: Basic definitions

Clause 2: Meaning of “associate”

11. This clause is the first of a series of definitions (arranged in alphabetical order). It is based on section 417(3) and (4) of ICTA.

12. The expressions defined in this series of clauses are used in defining “close company”. They are technical terms. Accordingly, for the convenience of the reader, their definitions are presented before the clauses in this Chapter which define “close company”.

Clause 3: Meaning of “associated company”

13. This clause defines “associated company”. It is based on section 416(1) of ICTA.

Clause 4: Meaning of “control”

14. This clause defines “control”. It is based on section 416(2) and (3) of ICTA.

15. *Subsection (1)* specifies that this definition of “control” applies for the purposes of this Part. The definition of “control” in section 840 of ICTA will also be rewritten in this Bill.

16. *Subsection (2)* rewrites the general proposition in the opening words of section 416(2) of ICTA.

17. *Subsection (3)* rewrites the specific propositions in section 416(2)(a) to (c) of ICTA.

18. *Subsection (4)* rewrites as a separate stipulation the parenthesis in section 416(2)(b) of ICTA.

19. *Subsection (5)* rewrites section 416(3) of ICTA.

20. Section 767B(4) to (6) of ICTA adopt with modifications the definition of “control” given by section 416 of that Act. Section 767B of ICTA is also being rewritten in this Bill. See clause 36[j7767Bb] under CC/SC (08) 22. Care is being taken to ensure that sections 416 and 767B(4) to (6) of ICTA are rewritten consistently, and clause [j7767Bb] will be conformed to this clause when the draft Bill is published next year.

Clause 5:: Section 4: rights to be attributed etc

21. This clause supplements clause 4. It is based on section 416(4) to (6) of ICTA.

22. *Subsections (2) and (3)* rewrite, respectively, section 416(4) and (5) of ICTA.

23. *Subsections (4) to (6)* rewrite section 416(6) of ICTA, paragraphing it and breaking it up into sense-units.

Clause 6: Meaning of “director”

24. This clause is a non-exhaustive definition of “director”. It is based on section 417(5) and (6) of ICTA.

25. Section 417(5)(b) of ICTA has the phrase “directly or through the medium of other companies or by any other indirect means”. It follows from the meaning of “other” that “through the medium of other companies or by any other indirect means” can be compressed to “by any indirect means”. Compare Viscount Radcliffe’s remarks on “interest, annuities, or other annual payments” in CIR v Frere (1964) 42 TC 125 HL on page 152. And, as a matter of normal English usage, “by any indirect means” is synonymous with “indirectly”. *Subsection (2)(b)(ii)* therefore compresses the phrase under review to “directly or indirectly”.

26. In section 417(6) of ICTA, if a person (P) is deemed to own whatever P’s associates own or control, then “either alone or with one or more associates” is otiose. *Subsection (3)* therefore omits it. And subsection (3) goes on to omit as otiose “even if he does not own or control share capital on his own”.

Clause 7: Meaning of “loan creditor”

27. This clause defines “loan creditor”. It is based on section 417(7) to (9) of ICTA.

Clause 8: Meaning of “participator”

28. This clause defines “participator”. It is based on section 417(1) and (2) of ICTA.

29. *Subsection (4)* refers to clause [j52092](2). See clause 4[j52092](2) under CC/SC (08) 23.

Q2. We welcome comments on the definitions in clauses 2 to 8.
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Clause 9: Meaning of “close company”

30. This clause is the first of a group of three clauses defining “close company”. It is based on section 414(1), (2) and (2D) of ICTA.

31. *Subsection (1)* provides that there are two alternative tests to determine whether a company is a close company.

32. The first test, condition A in *subsection (2)*, focuses on control over the company. “Control” has the meaning given by clause 4.

33. The second test, condition B in *subsection (3)*, focuses on rights to assets in the event that the company is wound up. To that end, subsection (3) coins the technical terms “majority winding up rights” and “relevant winding up rights”. *Subsection (4)* gives a signpost to the definitions of those terms in clause 10.

34. *Subsection (5)* gives a signpost to the exceptions to this clause in clauses 12 to 16.

35. *Subsections (6) and (7)* relate to condition B in subsection (3). Subsection (6) provides for subsection (3) to be supplemented by clause 5. Subsection (7) gives a signpost to clause 11, which supplements subsection (3).

Clause 10: Meaning of “majority winding up rights” and “relevant winding up rights”

36. This clause defines “majority winding up rights” and “relevant winding up rights” in clause 9(3). It is based on section 414(2), (2A), (2B) and (2D) of ICTA.

37. *Subsection (2)* defines “majority winding up rights”. In this subsection, “a company (C)” picks up both “a company” in *subsection (1)* and therefore picks up “a company” in clause 10(2) and (3); it also picks up “any other company” in clause 10(4).

38. *Subsection (3)* defines “the relevant assumption” (which is made in subsections (2) and (4)).

39. *Subsections (4) and (5)* define assumptions A and B in subsection (3)(b).

40. *Subsection (6)* defines “relevant winding up rights”.

41. *Subsection (7)* provides for this clause to be supplemented by clause 5.

42. Section 414(2) to (2D) of ICTA catch arrangements whereby someone who does not have “control” of a company within the broad definition of section 416 of ICTA is nevertheless entitled to the bulk of the company’s assets and income. Section 414(2) to (2D) are very compact. If the participators entitled to assets in the notional winding up include participators which are companies, the test may need to be applied iteratively.

Clause 11: Treatment of some persons as participators or directors for the purposes of section 9(3)

43. This clause supplements clause 9(3). It is based on section 414(2C) of ICTA.

Q3. We welcome comments on the definition of “close company” in clauses 9 to 11.

Q4. In particular, we welcome comments on the rewrite of section 414(2) to (2D) of ICTA.

Clause 12: Particular types of company

44. This clause is the first of a series of clauses stipulating that certain companies are not to be treated as close companies. It is based on section 414(1) and (2) of ICTA.

45. Bill 5 will insert a definition of “registered industrial and provident society” in section 834(1) of ICTA (interpretation of the Corporation Tax Acts). See paragraph 202(2)(g) of Schedule 1 to the draft Bill published for consultation in February 2008. This clause therefore omits the reference in section 414(1)(b) of ICTA to section 486(12) of that Act.

Clause 13: Companies controlled by or on behalf of Crown

46. This clause provides that certain companies controlled by or on behalf of the Crown are not to be treated as close companies. It is based on section 414(1) and (4) of ICTA.

47. *Subsection (1)* provides that “a company is not to be treated as a close company if *as a result of section 9(2)* it is controlled by or on behalf of the Crown.” The italicised words are based on “and not otherwise a close company” in section 414(1)(c) of ICTA.

48. The italicised words leave it open for a company controlled by or on behalf of the Crown to be a close company if condition B in clause 9(3) is met. Clause 9(3) is based on section 414(2) of ICTA.

49. The italicised words also leave it open for a company controlled by or on behalf of the Crown to be a close company if condition A in clause 9(2) is satisfied by reference to persons acting independently of the Crown. See *subsection (3)*.

50. In short, section 414(1)(c) of ICTA is a qualified exception to section 414(1) of that Act but not an exception to section 414(2) of that Act.

Clause 14: Companies involved with non-close companies

51. This clause provides that certain companies involved with non-close companies are not to be treated as close companies. It is based on section 414(5) and (6) of ICTA.

52. *Subsection (2)* rewrites section 414(5)(a) of ICTA.

53. *Subsection (3)* rewrites section 414(5)(b) of ICTA.

54. *Subsection (4)* uses the expression “UK resident”. Bill 6 will include a clause defining “UK resident” for the purposes of the Corporation Tax Acts as resident in the United Kingdom. Compare section 989 of ITA, which makes corresponding provision for the purposes of the Income Tax Acts.

Clause 15: Section 14: registered pension schemes

55. This clause supplements clause 14; it is concerned with shares held on trust for registered pension schemes. It is based on section 414(7) of ICTA.

56. *Subsection (1)* is based on the full-out words at the beginning and end of section 414(7) of ICTA. In summary, a registered pension scheme within subsection (1) is treated as a non-close company.

57. *Subsection (2)* is based on the “unless”-clause in the full-out words at the beginning of section 414(7). It is the first part of an exception to subsection (1). It focuses on the individuals for whose benefit the scheme is established.

58. *Subsection (3)* is based on section 414(7)(a) to (c) of ICTA. It is the second part of the exception to subsection (1). It focuses on the companies of which the individuals in subsection (2)(a) are or were directors or employees.

Clause 16: Particular types of quoted company

59. This clause provides that certain quoted companies are not to be treated as close companies. It is based on section 415(1), (2) and (6) to (8) of ICTA.

60. *Subsection (1)* lays down the general rule.

61. *Subsection (2)* makes an exception to this rule.

62. Subsection (2) uses the concept of a “principal member” of a company. This term is defined in *subsection (3)*.

63. *Subsection (4)* qualifies subsection (3).

64. Subsections (1) to (4) focus on voting power. *Subsection (5)* supplements the references to voting power in those provisions.

65. In section 415(1)(a) of ICTA, “whether with or without a further right to participate in profits” is otiose. *Subsection (6)(b)* therefore omits it for the sake of brevity. This will not leave it open for “entitled to” in subsection (6)(b) to be read as “only entitled to”. In this Bill, where the sense is “only entitled to” the drafting convention is to use wording which makes this expressly clear. See clause 64[j4821rm](5) (group relief: equity holders and profits and assets available for distribution: meaning of “ordinary shares”) under CC/SC (07) 27 and clause 7[j2034aa](2)(c) (relief for small companies: associated companies: definition of “fixed-rate preference shares”) under CC/SC (08) 03.

Clause 17: Section 16: meaning of “shares beneficially held by the public” etc

66. This clause supplements clause 16. It is based on section 415(3) to (8) of ICTA.

- 67. *Subsection (1)* lays down the general rule.
- 68. *Subsection (2)* makes an exception to that rule.
- 69. *Subsection (3)* specifies the individuals in subsection (2)(e).
- 70. *Subsection (4)* rewrites the tail words of section 415(3) of ICTA. It supplements the references to unconditional allotment and unconditional acquisition in clause 16(1).
- 71. *Subsections (5) to (8)* supplement this clause or provisions of this clause.

Q5. We welcome comments on clauses 12 to 17.

Chapter 3: Charge to tax in case of loan to participator

Clause 18: Charge to tax in case of loan to participator

72. This clause imposes a charge to tax if a close company makes a loan, or advances money, to a participator or an associate of a participator. It is based on section 419(1) to (3), (6) and (7) of ICTA.

73. *Subsection (1)* states when this clause applies. It uses the expression “relevant person”, which is defined in *subsection (6)*.

74. *Subsection (2)* imposes the charge.

75. *Subsection (3)* states when the tax is due and payable.

76. *Subsection (4)* extends the scope of the charge. It is based on section 419(2) of ICTA, which is expressed to apply for the purposes of that section. Subsection (4) is expressed to apply for the purposes of, among other things, clause 19 – that is, including the provisions of that clause which are based on section 420 of ICTA. Since section 420 of ICTA makes exceptions to section 419 of that Act, defining the scope of subsection (4) in this way will not change the law.

77. *Subsection (5)* extends the circumstances in which a person is treated as being a participator in a company.

Clause 19: Exceptions to the charge under section 18

78. This clause makes certain exceptions to the charge under clause 18. It is based on sections 419(1) and 420 of ICTA.

79. *Subsection (1)* is an exception for money-lending companies.

80. *Subsection (2)* is an exception for ordinary supplies of goods and services.

81. Subsections (3) to (8) are an exception for small amounts.

82. Subsections (3), (4) and (7) apply not only to loans but also to advances. This is a minor change in the law to bring it into line with practice. See *Change 666* in Annex 1.

Q6. We welcome comments on the proposal to extend the exception made by clause 19 to advances (Change 666).
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83. This clause does not rewrite the provisions of section 420(2) of ICTA concerning loans made before 31 March 1971. A saving for those provisions will be drafted in due course.

Clause 20: Section 19: meaning of “material interest in a company”

84. This clause defines “material interest in a company” for the purposes of the exception for small amounts in clause 19. It is based on section 420(2) of ICTA.

85. The closing sentence of section 420(2) of ICTA attracts, with modifications, section 168(11) of ICTA. Section 168(11) of ICTA has been rewritten in section 68 of ITEPA and repealed. This clause largely replicates section 68 of ITEPA.

86. Section 168(11) of ICTA is reproduced below for the reader’s convenience, as it stood before ITEPA and as modified by section 420(2) of ICTA.

“A person shall be treated as having a material interest in a company if he, either on his own or with one or more associates, or if any associate of his with or without such other associates –

- (a) is the beneficial owner of, or able, directly or through the medium of other companies, or by any other indirect means, to control more than 5 per cent of the ordinary share capital of the company, or
- (b) in the case of a close company, possesses, or is entitled to acquire, such rights as would in the event of the winding up of the company or in any other circumstances, give an entitlement to receive more than 5 per cent of the assets which would then be available for distribution among the participators.

In this subsection “associate” has the same meaning as in section 417(3), ~~except that for this purpose “relative” in that subsection has the meaning given by section 160(6), and “participator” has the meaning given by section 417(1).~~”

87. The closing sentence of section 420(2) of ICTA provides for the words following “417(3)” to be omitted, and the words in strikethrough reflect this. It is,

however, considered that this omission merely disapplies the definition of “relative” in section 160(6) of ICTA and that it does not extend to the underlined words, because omitting the underlined words would leave “participator” undefined. FA 1989 inserted the underlined words into section 168(11) of ICTA by way of consequential amendment, and it appears that the need to make a further consequential amendment to section 420(2) of that Act was overlooked.

88. The opportunity has been taken to compress *subsection (2)(b)* for the sake of brevity and consistency with clause 6(2)(b)(ii). See the commentary on that provision.

Clause 21: Relief in case of repayment or release of loan

89. This clause gives relief from tax in cases in which:

- a loan or advance from a close company has given rise to a charge under clause 18, and
- the loan or advance is repaid or the debt in respect of it is released or written off.

90. It is based on section 419(4) to (4B) of ICTA.

91. *Subsection (1)* states when the clause applies.

92. *Subsection (2)* specifies the relief and the circumstances in which it is given.

93. *Subsection (3)* is about claiming the relief. Paragraph 21 of Schedule 39 to FA 2008 will substitute “4 years” for “six years” in section 419(4) of ICTA. This amendment is to be made with effect from a date which, at the time of writing, has not yet been appointed, and subsection (3) therefore does not anticipate this amendment.

94. If the company becomes eligible for relief after the tax due under clause 18 becomes due and payable, *subsections (4) and (5)* defer the relief.

95. *Subsection (6)* sets the link with TMA.

Clause 22: Loan treated as made to participator

96. This clause blocks arrangements to circumvent the charge under clause 18. It treats certain loans or advances, which would otherwise be outside the scope of that clause, as having been made to a relevant person. It is based on section 419(5) and (7) of ICTA.

97. *Subsection (1)* states when the clause applies.

98. *Subsection (2)* is the main operative provision.

99. Section 419(5) of ICTA provides for that section to apply as if the loan or advance had been made to the individual in question. Subsection (2), which is based on section 419(5), provides for clauses 18 to 21 to apply. These clauses include provisions which are based on section 420 of ICTA. Since section 420 of ICTA makes exceptions to section 419 of that Act, defining the scope of subsection (2) in this way will not change the law.

100. *Subsection (3)* makes two exceptions to this clause.

101. *Subsection (4)* extends the circumstances in which a person is treated as a participator in a company.

Clause 23: Loan treated as made by close company

102. This clause extends the scope of clauses 18 to 22 to catch loans or advances made by certain companies which are controlled by other companies. It is based on section 422(1) to (3) and (6) of ICTA.

103. *Subsection (1)* states when the clause applies.

104. *Subsection (2)* prescribes the consequences if the company (C) making the loan or advance is controlled by a close company.

105. *Subsection (3)* prescribes the consequences if C is not controlled by a close company but a close company subsequently acquires control of it.

106. Subsections (2) and (3) operate in relation to clause 22, because the references in section 422(1) and (2) of ICTA to section 419 of that Act pick up section 419(5) of that Act.

107. *Subsection (4)* deals with the case in which two or more close companies control C.

108. *Subsections (5) and (6)* are signposts.

109. *Subsection (7)* extends the circumstances in which a company is deemed to make a loan.

Clause 24: Exception to section 23

110. This clause makes an exception to clause 23. It is based on section 422(4) and (6) of ICTA.

Clause 25: Determination of particular questions as a result of section 23

111. This clause supplements clauses 18 to 23. It is based on section 422(5) and (6) of ICTA.

112. *Subsection (1)* states when the clause applies. It operates in relation to clause 22 for the reason given in the commentary on clause 23(2) and (3).

113. *Subsection (2)* lists the questions which come within this clause, and requires them to be determined by reference to the company labelled C in clause 23(1).

Clause 26: Taxation of debtor on release of loan to trustees of settlement which has ended

114. This clause deems income to arise to a company for corporation tax purposes in certain circumstances when a loan or advance from a close company is released or written off. It is based on section 421 of ICTA.

115. This clause deals with the following case, as specified in *subsections (2) to (5)*.

- A close company (X) makes a loan or advance to the trustees of a settlement.
- Another company (Y) becomes the debtor in respect of this loan or advance.
- After the settlement has ended, X releases or writes off the whole or part of the loan or advance.

116. *Subsection (6)* is the main operative provision. It states (a) that income arises to Y for corporation tax purposes and (b) when this income arises.

117. *Subsection (7)* quantifies the income.

118. Section 998 of ITA (meaning of “grossing up”) does not, of course, define any of the terms in section 421(1)(a) of ICTA. But section 421(1)(a) of ICTA uses the word “gross” in a manner analogous to section 998(1) and (2) of ITA. Subsection (7) therefore uses a formula to rewrite section 421(1)(a) and (b) of ICTA on the lines of the formula in section 998(3) of ITA.

Clause 27: Section 26: other person treated as releasing or writing off debt

119. This clause supplements clause 26. It is based on section 422(5) of ICTA.

120. *Subsection (1)* states when the clause applies. It operates in relation to clause 22 for the reason given in the commentary on clause 23(2) and (3).

121. *Subsection (2)* is the operative provision.

Q7. We welcome comments on clauses 18 to 27.

Chapter 4: Power to obtain information

Clause 28: Power to obtain information

122. This clause gives HMRC power to obtain information. It is based on Schedule 12 to FA 1989.

123. *Subsection (1)* includes a minor change in the law: it expressly restricts the particulars to be provided to those which an officer of Revenue and Customs may reasonably require. See *Change 608* in Annex 1. This change is also proposed in the legislation on transactions in land. See clause 19[j6178a](1) under CC/SC (07) 29 and the commentary thereon.

Q8. We welcome comments on the proposal to impose the criterion of reasonableness in clause 28(1) (Change 608).

124. For the sake of consistency, *subsection (6)* also expressly imposes the test of reasonableness. Since this test is implicit in the source legislation, making it explicit is not a change in the law.

125. This Bill will rewrite sections 708 and 778 of ICTA, which are powers to obtain information relevant to the anti-avoidance provisions concerned with, respectively, transactions in securities and in land. See clause 22[j6708] under CC/SC (07) 28 (transactions in securities) and clause 19[j6178a] under CC/SC (07) 29 (transactions in land). To be consistent with that approach, this clause will rewrite Schedule 12 to FA 1989 in its application to the close company legislation rewritten in this Part of the Bill, and clause [j52343] will rewrite that Schedule in its application to section 234(9) of ICTA (information relating to distributions). See clause 109[j52343] under CC/SC (08) 23. We are considering the extent to which Schedule 12 to FA 1989 should be rewritten in this Bill in its application to other provisions. The definition of “the relevant provisions” in *subsection (7)* is therefore under review and subject to change.

Q9. We welcome comments on clause 28.

Annex 1

Change 666: Close companies: charge to tax on loans and advances to participators: exception for small amounts: clause 19

This change brings into line with practice the statutory exception, for small amounts, from the charge to tax on loans and advances made to participators in close companies. It does so by extending the exception to include not only loans but also advances.

Section 419 of ICTA imposes a charge to tax when a close company (otherwise than in the ordinary course of a business carried on by it which includes the lending of money) makes any loan or advances any money to an individual who is a participator in the company or to an associate of a participator in the company.

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Section 420(2) of ICTA makes an exception to this charge when the amounts are small. So far as relevant, it provides:

“Section 419(1) shall not apply to a loan made to a director or employee of a close company, or of an associated company of the close company, if –

- (a) neither the amount of the loan, nor that amount when taken together with any other outstanding loans which –
 - (i) were made by the close company or any of its associated companies to the borrower; and
 - (ii) if made before 31st March 1971, were made for the purpose of purchasing a dwelling which was or was to be the borrower’s only or main residence;

exceeds £15,000 and the outstanding loans falling within subparagraph (ii) above do not together exceed £10,000; ... and

- (c) the borrower does not have a material interest in the close company or in any associated company of the close company;

but if the borrower acquires such a material interest at a time when the whole or part of any such loan made after 30th March 1971 remains outstanding the close company shall be regarded as making to him at that time a loan of an amount equal to the sum outstanding.”

Section 420(2) of ICTA makes no reference to advances. However, it would be anomalous to exclude advances from section 420(2), because an advance to a participator in a close company would then be subject to the charge under section 419 of ICTA in circumstances in which, if the participator had received the money by way of loan, section 420(2) would have sheltered it from tax.

In practice, therefore, HMRC apply section 420(2) of ICTA to loans and advances alike.

Clause 19, which is based on section 420(2) of ICTA, brings the law into line with practice.

This change is in taxpayers’ favour in principle. But it is expected to have no practical effect as it is in line with generally accepted practice.

Change 608: Transactions in land and close companies: power to obtain information: “reasonably require”: clauses [j6178a], [j52343] and 28

This change expressly restricts the particulars that an officer of Revenue and Customs may require to be provided under section 778(1) of ICTA or [(in its application to

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close companies)] paragraph 2 of Schedule 12 to FA 1989 to the information which the officer may reasonably require.

Section 778(1) of ICTA enables the Board or an inspector to require a person to give them such particulars “as the Board or the inspector think necessary” for the purposes of section 776 of that Act.

Paragraph 2 of Schedule 12 to FA 1989 similarly enables an inspector to require a company to furnish the inspector with such particulars “as he thinks necessary” for the purposes of, among other things, sections 419 to 422 of ICTA.

In clause [j6178a], which is based on section 778(1) of ICTA, and clauses [j52343] and 28, which are based on paragraph 2 of Schedule 12 to FA 1989, the opportunity has been taken to modernise this language and expressly impose the criterion of reasonableness. This is consistent with the way in which HMRC exercise the power in practice.

This change has no implications for the amount of tax paid, who pays it or when. It affects (in principle but not in practice) only administrative matters.