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PRACTICE NOTE

PN 202/18 **Date: 10 July 2018**

2018 BUDGET CHANGES: PAYMENTS TO PARTICIPATORS RELATING TO SALES OF GOODWILL OR UNQUOTED SHARES

Please note that this guidance is an updated and replacement version of PN 202/18, which was originally published on 20 February 2018. The original PN is reproduced below and is followed by an update.

INTRODUCTION

As part of the 2018 Budget, the Minister for the Treasury, the Hon. A L Cannan, MHK, announced the introduction of measures aimed at reducing the tax loss that can occur when Isle of Man companies are used to convert income (which is taxable) into capital gains (which are not taxable in the Isle of Man).

The changes apply in respect of payments made on or after 20 February 2018.

BACKGROUND

Under Isle of Man law income is taxable but capital gains are not and this difference in tax treatment can influence the way in which taxpayers structure their affairs. In recent years the Assessor of Income Tax has become aware of Isle of Man companies being used to convert what would have otherwise been taxable income into capital gains and is challenging these arrangements using her broad anti-avoidance powers in Schedule 1 to the Income Tax Act 1980. However, the application of these powers is complex and time consuming for all involved.

In 2017, the Treasury Minister announced in his Budget speech that he would support the introduction of a Temporary Taxation Order to remove the potential tax advantages of using Isle of Man companies to convert income into capital in certain circumstances.

The methods of converting income into capital most commonly seen by the Assessor involve Isle of Man companies that are closely held and the use of shareholder loan accounts. This can include the introduction of goodwill and more aggressive types of structuring involving the transfer or sale of unquoted shares by an individual to their own company.

As a result, the Income Tax (Non-Corporate Taxpayers) (Temporary Taxation) Order 2018 (SD 2017/0377) introduces legislation to address these measures, and takes effect on 20 February 2018. This legislation is intended to stop certain practices which have been aimed at allowing individuals to receive tax-free payments from companies in preference to taxable payments.

The legislation does not affect the tax treatment of companies which remains unchanged.

BUDGET CHANGES: SECTION 2PB

The Assessor has become aware of a practice of crediting loan balances with the purchase cost of either goodwill or of unquoted shares purchased from the participator. These loans are then repaid using the money that is, in essence, the taxable profit of the company arising from the goodwill or shares, rather than a taxable dividend being paid. Where the Assessor considers that the motive for this practice is the avoidance or reduction of tax, any payments that have already been made may be assessed under Schedule 1 to the Income Tax Act 1980.

In order to protect the Revenue going forward however, and rather than dealing with this on a case-by-case basis, section 2PB has now been introduced into the Income Tax Act 1970. This will work on two levels:

1. In cases where there has been a purchase of goodwill and/or unquoted shares <u>between 6 April 2011 and 20 February 2018</u> and the purchase has resulted in a debt owed to a participator, then any repayment of this debt to the participator on or after 20 February 2018 is treated as being a dividend for income tax purposes first, to the level of the company's undistributed taxable profits, up to either:

   a) the level of debt arising from the purchase; or
   b) the loan account credit balance as at 20 February 2018,

   whichever is the lower amount.

2. Where there is a purchase of goodwill and/or unquoted shares <u>on or after 20 February 2018</u> then:

   a) the purchase transaction itself is treated as being a dividend for income tax purposes at the time it is made, to the level of the company's undistributed profits at that time; and
   b) if the purchase value exceeds the level of undistributed company profits at that time then any loan repayments made in subsequent years are also treated as being a taxable dividend payment up to the value of the original purchase less any amounts already taxed under section 2PB.

The new measure is effectively an ordering mechanism to ensure that company income used to fund loan repayments relating to a purchase of goodwill and/or shares from the paricipator's own company is taxed first before any tax-free capital payments can then be taken. There is no intention of introducing any form of capital gains tax in the Isle of Man and all capital gains and transactions will continue to be tax-free. The only difference now is that members of companies will not be able to benefit from these types of transactions until after they have first paid out all taxable profits from the company for income tax purposes, either as normal dividends or as loan repayments that are now treated as being dividends under section 2PB.

1. Payments made to a participator on or after 20 February 2018 due to the sale of goodwill or unquoted shares to a company between 6 April 2011 and 20 February 2018

Where a participator is owed an amount from an Isle of Man company due to the sale of goodwill or unquoted shares made to their own company between 6 April 2011 and 20 February 2018, and the company has not distributed all of its retained profits, then an element of any loan repayment made in respect of this debt will be treated as being a dividend for income tax purposes first, before the participator can receive the balance of any loan repayments as capital.

In this case, the loan repayments will be treated as being a dividend up to the level of the undistributed taxable profits of the company but also up to the level of either:

(i) the amount for which the goodwill or shares were sold to the company; or
(ii) the amount of this debt remaining as still due to the participator at 20 February 2018,

whichever is the lower.

Example:

A participator is owed a loan account repayment of £600,000 as at 20 February 2018 and there was a sale of goodwill 5 years earlier of £500,000. During the YE 31 March 2018 the participator was repaid £550,000 from their loan account and also received a dividend payment of £80,000.

Retained taxable profits brought forward	£1,000,000
Company taxable profit YE 31/03/2018	£80,000
Less dividends paid in YE 31/03/2018	(£80,000) – Taxable under section 2PA
Retained taxable profits	£1,000,000
Loan account repayment to participator	(£500,000) – Treated as dividend under section 2PB
Retained taxable profits	£500,000
Loan account repayment to participator	(£50,000) – Capital repayment

Because part of the loan repayment relates to a previous sale of goodwill it means that £500,000 (being the lower of the loan account credit on 20 February 2018 and the cost of the goodwill) will be treated as being a dividend first, in accordance with section 2PB, before the participator can receive the remaining £50,000 capital repayment for income tax purposes.

Alternatively, in this example, if the loan repayment was £100,000 per year over a five year period it would mean that each year's loan repayment would be treated as being a taxable dividend. As soon as the full value of goodwill of £500,000 has been taxed in this way any further loan repayments could then be taken as capital from the 6th year onwards.

2. Sale of goodwill or unquoted shares from participator to their company on or after 20 February 2018

Where a participator sells goodwill or unquoted shares to their company on or after 20 February 2018 the value of this sale is immediately treated as being a dividend paid to the participator up to the level of undistributed profits at the end of that year or the sale value, whichever is the lesser amount. This is regardless of what level of loan repayments are actually taken in that year.

Where the undistributed profits in the year of sale are less than the sale value, loan repayments made in subsequent years are also treated as being a dividend paid out of company profits at the time the repayment is made, up to the original sale value less any amount already taxed in previous years.

Example:

An individual incorporates their self-employed business on 1 April 2018 and sells goodwill to their new company for a value of £500,000. This amount is recorded as a debt owed to the participator from the company via a loan account credit. During the first year ending 31 March 2019 the company has profits of £150,000 whilst the participator takes a loan repayment of £50,000 and receives a dividend of £20,000:

Company taxable profit YE 31/03/2019	£150,000
Less dividends paid in YE 31/03/2019	(£20,000) – Taxable under section 2PA
Retained taxable profits	£130,000

Section 2PB taxable distribution YE 31/03/2019	(£130,000) – Based on sale of goodwill in year
Retained taxable profits	nil

The level of retained profits after dividend up to 31 March 2019 is treated as being a taxable dividend under section 2PB.

The loan repayment made to the participator in the year is less than the £130,000 charged as a dividend on sale under section 2PB, and is not also subject to the 2PB charge on loan repayments.

During the following year ended 31 March 2020 the company has profits of £200,000 and the participator receives dividends of £30,000 and loan repayments of £100,000.

Company taxable profit YE 31/03/2020	£200,000
Less dividends paid in YE 31/03/2020	<u>(£30,000</u>) – Taxable under section 2PA
Retained taxable profits	£170,000
Loan account repayment to participator	<u>(£100,000)</u> – Treated as dividend under section 2PB
Retained taxable profits	£70,000

The loan repayments are now treated as being dividends made from company profits under section 2PB as long as they remain less than the undistributed company profits for each year and also as long as the total amount taxable under section 2PB is within the original sale value of the goodwill or shares.

SUMMARY

The new section 2PB is a targeted measure to discourage market value sales of goodwill and unquoted shares from participators to their own companies. Where this happens the sale proceeds will be treated as being a taxable dividend made out of the company profits and into the participator's hands.

If the sale happened between 6 April 2011 and 20 February 2018, any loan repayments made on or after this date are treated as being dividends.

If the sale happens on or after 20 February 2018 the sale value itself is treated as being the dividend made from company profits, regardless of what repayments are actually taken in that year. If the sale value exceeds the level of undistributed profits at that time then any subsequent loan repayments are also treated as being taxable dividends up to the level of the sale value less any amounts already treated as being dividends under section 2PB.

JULY 2018 UPDATE

Treasury will amend the new legislation when the Temporary Taxation Order is included in the next Income Tax Bill. It is proposed that this amendment will be introduced with effect from the date of the original Order.

As it is proposed that an amendment should be introduced with effect from the date of the original Order, the Treasury has requested the Assessor not to apply the new section 2PB of the Income Tax Act 1970 in the following scenarios.

1) Where it can be evidenced to the Assessor that the sale of unquoted shares has taken place via a share for share exchange only with no resulting payments or debt being owed to the participator.

- This applies where shares in company A are transferred to company B in return for receiving an equivalent number of shares in company B. No money changes hands and no debt is owed as a result of this transaction. There is therefore no scope for company profits to be paid out as consideration on the purchase of the shares.

2) Where it can be evidenced to the Assessor that the sale of unquoted shares does not create an untaxed extraction of undistributed profits either at the time of sale or at any time in the future.

   - If an individual can demonstrate that their sale of shares to their own company does not allow them in any way to extract the tax-free benefit of any retained income reserves from their company, at any time, then the Assessor will exclude this transaction from section 2PB.

3) Where it can be evidenced to the Assessor that on the sale of unquoted shares any payments made or debt owed to the participator from that sale directly correspond with the amount of consideration paid by unconnected third parties.

   - For example, where the sale of shares to a new holding company involves some change in the ultimate beneficial ownership and the new owner injects an amount of capital into the holding company to fund the purchase of shares from the original owner.

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