The Taxing Wealth Report 2024

Every politician's guide to "How to pay for it"[1]

The reform of corporation tax:

Reintroducing close company rules

Brief Summary

This note proposes that close company rules be reintroduced into UK taxation. It should be required as a result that:

1. The income of all close companies with retained investment income and gains exceeding £50,000 should be required to distribute such sums to their members or they shall be deemed to have done so for income tax purposes.

2. The retained profits of all close trading companies in excess of £200,000 not demonstrably being used for the purposes of a trade shall likewise be required to be distributed to the members of that company or shall be deemed to be so for income tax purposes.

For these purposes a close company is defined as a company:

- under the control of:

[1] This note forms a part of 'The Taxing Wealth Report 2024' published by Finance for the Future LLP, which is UK LLP number OC329502, registered at 33 Kingsley Walk, Ely, Cambridgeshire, CB6 3BZ. See https://www.financeforthefuture.com/taxing-wealth/. This note was written by Richard Murphy FAcSS FCA FAIA (Hon), Professor of Accounting Practice, Sheffield University Management School, who is a director of Finance for the Future LLP. © Finance for the Future LLP 2023

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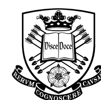
Finance for the Future and  Sheffield University Management School

- five or fewer participators, or
- any number of participators if those participators are directors.

- Or companies where more than half the assets of which would be distributed to five or fewer participators, or to participators who are directors, in the event of the winding up of the company.

A participator is usually a shareholder or director, although loan creditors can occasionally count if they have influence over a company.

The proposal	To reintroduce close company rules into UK taxation to prevent those able to do so from accumulating wealth subject only to the low tax rates charged on the income and gains of companies when those income and gains are not used for the purposes of a trade but are instead retained in a company for the purposes of avoiding taxes. These rules would require that: 1. The income of all close companies with retained investment income and gains exceeding £50,000 should be required to distribute such sums to their members or they shall be deemed to have done so for income tax purposes. 2. The retained profits of all close trading companies in excess of £200,000 not demonstrably being used for the purposes of a trade shall likewise be required to be distributed to the members of that company or shall be deemed to be so for income tax purposes.
Reason for the proposal	1. To prevent one of the most common forms of tax avoidance by those with income and gains in excess of their need for current expenditure, which funds can be sheltered from tax by retaining them in lowly taxed private limited companies. 2. To improve the horizontal equity of the UK tax system by preventing the abuse of private limited companies

	that currently create a massive imbalance in that form of equity. 3. To increase vertical tax equity. 4. To reduce the incentive to avoid tax. 5. To reduce the tax spillover effect that private limited companies create 6. To raise additional tax revenues in a more progressive fashion.
Estimated tax that might be raised as a result of the recommendation made	The behavioural responses to this recommendation cannot be known for certain, but it is bound to lead to a considerable increase in the rate of distribution of profits from many privately owned companies, and so to the overall tax rate of the shareholders of those entities. It will as a result have a favourable impact on horizontal and vertical tax equity as well as in decreasing inequality. Given the number of variables involved it is hard to estimate the sums likely to be distributed, but if only £10 billion was distributed a year as a result of this policy (and that would appear to be a modest estimate) the likely increase in tax yield might be more than £3 billion a year at current tax rates, and somewhat more at the rates of tax proposed in the Taxing Wealth Report 2024, especially if an investment income surcharge was taken into account.
Ease of implementation	The changes proposed will be easy to implement. No technical difficulties should arise because this is already known legislation.
Likely difficulties that might result from implementation	There is likely to be significant opposition to these changes but that is the only difficulty that should be anticipated.
Likely time required to implement the change	Capable of being delivered in any Finance Bill i.e. in a matter of months. At least twelve months notice of the

	change might, however, be beneficial with few tax risks arising.
Consultation period required.	It is likely that at least a year's notice of these changes would be required.

Background

One of the most serious problems faced when tackling the shortfall of tax paid by those with wealth and associated high levels of income is the ability of those in that fortunate position to shelter both their income and wealth from taxation by recording it in companies that they, or trusts that they control, own. This issue was noted by the EU Tax Observatory in 2023, when they suggested[2] that this fact was, in isolation, one of the biggest reasons why this group in society pay such an overall low level of tax on their income and wealth.

This is not a new problem. The issue was anticipated in the UK from the time that corporation tax was introduced in 1965. So-called 'close company provisions' were created tackle this issue. In the USA and the UK's Crown Dependencies these rules are given different names. In the USA, they are described as 'flow-through' taxation based on the existence of 'flow-through' entities[3]. In the Isle of Man companies falling under a not-dissimilar regime are subject to what is called a 'distributable profits charge'[4].

Whatever name is used, the purpose of such rules is basically the same. What they require is that some or all of the income and gains that a private limited company might make are not taxed as if they are the property of the company that legally generated them, but are instead taxed as if they belong to the shareholders or members of that limited liability company.

In the UK, at present, this rule only usually applies to the income of what are described as limited liability partnerships (LLPs). As their name implies, these legal entities are structured as if they are partnerships, but unlike most organisations described as such they have an existence that is legally distinct from the partners themselves. However, when it comes to tax, all of the income and gains of these LLPs is recorded as belonging to the individual members, who then pay tax on them as if they are the highest part of their income for taxation purposes. As such, personal income tax is paid on the profit of these organisations,

[2] https://www.taxobservatory.eu/publication/global-tax-evasion-report-2024/
[3] https://www.investopedia.com/terms/f/flow-through.asp
[4] https://www.gov.im/categories/tax-vat-and-your-money/income-tax-and-national-insurance/business-and-corporations/distributable-profits-charge/

whilst any capital gains are taxed as if they belong to the members and not to the partnership.

In the case of limited liability partnership, this apportionment of the income of the organisation includes the trading profit. This, however, need not be the case. Under the UK's close company taxation rules that broadly existed from 1965 until 1984, the trading profits of close companies could be retained by it for its own use so long as the company could demonstrate that that were commercial reasons for doing so. Tests to achieve this were established at that time and could be revived.

The companies subject to this rule, and which are still defined as close companies, were according to HM Revenue & Customs[5]:

- Companies under the control of:
    - five or fewer participators, or
    - any number of participators if those participators are directors.
- Or companies where more than half the assets of which would be distributed to five or fewer participators, or to participators who are directors, in the event of the winding up of the company.

Participators are defined[6] as any person having a share or interest in the capital or income of the company, which can in some cases include the providers of loan finance. The reality is that the vast majority of UK companies are close companies using this definition. If, however, a de minimis test was to be applied on both trading profits and unearned investment income and gains, with a much lower limit for the latter, the vast majority of companies would also fall out of the scope of these provisions[7].

That said, if the income and gains of a close company arising from non-trading activities gave rise to retained profits above the de minimis limit then that company would either be required to distribute the retained profits to its members by way of dividends, meaning that the income in question would then become taxable in the hands of its members, or it would be deemed to have done so, giving rise to the same net outcome with the members of the company being taxed as if they had received the income in question.

Note that the calculation is with regard to retained profits, and not profits arising in a year.

[5] https://www.gov.uk/hmrc-internal-manuals/company-taxation-manual/ctm60060
[6] https://www.gov.uk/hmrc-internal-manuals/company-taxation-manual/ctm60107
[7] Based on HMRC data at least 83% of UK companies have taxable income of less than £50,000 per annum and the de minimis might be set higher than that.

The same would be true if a close company made trading profits giving rise to retained profits above the de minimis limit without being able to justify their retention for trading purposes. In that case they too would be required to distribute those profits in the way noted above, or be deemed to have done so.

Disputes did, of course, arise between companies and the UK's tax authorities with regard to the use of profits by trading companies, but the great advantage of that for current purposes is that as a result guidance already exists that could guide the use of this legislation in future.

In practice, it is also the case that much of the close company legislation that might be required to reintroduce this charge to tax does still exists since close companies remain a concept within UK taxation, with the definition still being used as part of other tax law. The task of innovating this legislation should not, therefore, be onerous.

Recommendation.

It is recommended that close company rules be reintroduced to UK taxation.

It should be required as a result that:

1. The income of all close companies with retained investment income and gains exceeding £50,000 should be required to distribute such sums to their members or they shall be deemed to have done so for income tax purposes.

2. The retained profits of all close trading companies in excess of £200,000 not demonstrably being used for the purposes of a trade shall likewise be required to be distributed to the members of that company or shall be deemed to be so for income tax purposes.

Discussion

There will, inevitably, be objections to this proposal because it has direct impact on one of the most commonplace tax planning tools used by those with wealth in the UK.

The development of guidance for companies to follow so that they might indicate relevant and evidenced reasons for retaining profit within trading companies will be crucial to the overall acceptability of the scheme.

Fairly straightforward rules on the recognition of the makeup of retained profits of a company will also be required to make these close company rules work. They should allow for retrospective application in the event that a close company has significant retained and apparently unutilised reserves at the time of introduction of new close company rules.

The approach to be used by HMRC to the application of these rules on trading companies should be principles based. In other words, if it could be demonstrated that a close trading company has the clear intention to grow, requiring the retention of profit for investment in either fixed or working capital then, broadly speaking, a relaxed approach towards the application of this rule should be used by HM Revenue & Customs. In the absence of clear evidence on this issue, however, particularly over a period of time, HMRC must be empowered to act to require that profits are distributed or are deemed to be so, and that they therefore become subject to tax in the hands of the shareholders of these companies.

Penalties for failing to distribute profits when required to do so by close company rules would have to be available in case of need to use them.

Ownership by trusts

In the event of a company is owned either directly or indirectly, via a trust, then profits required to be distributed should be attributed to those who might be beneficiaries of that trust. In the absence of apparent beneficiaries tax should be charged on the trustees as if they are UK tax resident with liability being due at the top rate of income tax with all other recommendations made in the Taxing Wealth Report 2024 applying, if they are adopted. The use of trusts should not be a way to avoid these charges.

Groups of companies

In the case of groups of close companies, distribution should be determined on the basis of group consolidated accounts, which must be made available for this purpose. In the case of there being minority interests inside such groups appraisal should continue to be made on an individual entity basis.