CHAPTER 35

ADMINISTRATION AND LIQUIDATION

35.1 Introduction

In this chapter we are going to look at the tax implications of a company going into **administration** or **liquidation**. There is a distinction between an administrator and a liquidator.

A company which is in financial difficulty may go into **administration**. An 'administrator' is appointed to manage the company's affairs. The **company continues to trade** and the administrator normally seeks to **sell the company as a going concern**. If this is not possible, the administrator will normally achieve a better price for the company's assets than would be likely if the company went straight into liquidation.

Liquidation brings the existence of the company to an end. When a company is 'wound up' a liquidator is appointed to sell all the assets, pay all the debts and return any surplus capital to the shareholders. On completion of the winding up the company is dissolved. Liquidation can be voluntary or compulsory.

Voluntary liquidation is where the company chooses to be liquidated. This normally applies where the **company is solvent**. The liquidation starts when the members pass a resolution to wind up the company voluntarily.

Compulsory liquidation is when the company is ordered by a court to be wound up on the petition of perhaps the company's creditors, directors or one or more members. This normally applies where the **company is insolvent** and cannot pay its debts.

In either case the **liquidator** becomes the **beneficial owner** of the company's assets and is responsible for the payment of all corporation tax liabilities arising after the commencement of winding up.

35.2 Effect on accounting periods

Companies in administration

The appointment of an administrator causes a **new accounting period to begin.** The old accounting period ends the day before the appointment and a new one begins on the day of the appointment.

CTA 2009, s.10(1,2)

During the administration period, the normal rules with respect to accounting periods apply.

When a company moves out of administration an accounting period will come to an end.

Companies in liquidation

The appointment of a liquidator causes a **new accounting period to begin.** As with the appointment of an administrator, the old accounting period ends the day before the appointment and a new one begins on the day of the appointment.

CTA 2009, s.12(2,3)

Once a liquidator is in place the accounting period will end on the earlier of 12 months or the conclusion of the winding up. This means that if the **company ceases to trade once the liquidator is appointed this will not result in the end of an accounting period.**

CTA 2009, s.12(4)

However, if the company moves out of liquidation and into administration, an accounting period comes to an end at that date and a new one begins.

Illustration 1

Farcaso Ltd has a year end of 30 September.

On 1 December 2009 a liquidator is appointed, the company ceases to trade on the 12 March 2010 and the liquidation is finally completed on the 14 January 2011.

The accounting periods for the company will be:

1 October 2008 to 30 September 2009
1 October 2009 to 30 November 2009
1 December 2009 to 30 November 2010
1 December 2010 to 14 January 2011

Thus we do not end an accounting period when the trade ceases on 12 March 2010 as the liquidator is in place.

If the company ceases to trade before the liquidator is in place then we follow the normal rules and an accounting period will end.

If the company is a close company it may become a close investment holding company (CIHC) when trade ceases. The section relating to CIHC in the legislation has a clause specifically dealing with the position when a company is being wound up.

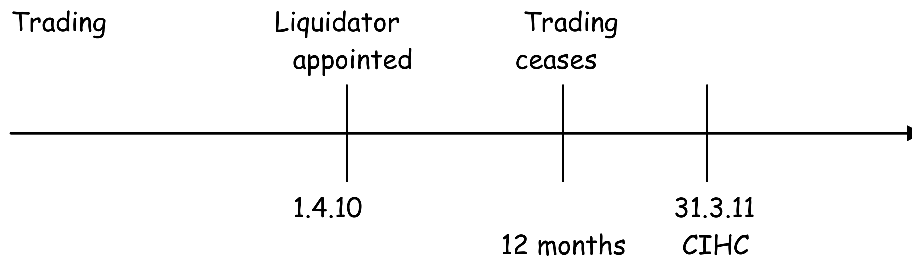
The first accounting period of a winding up will not lead to the company being treated as a CIHC provided that the company was not a CIHC in the accounting period that ends as the winding up starts. In other words, if trade ceases during the first accounting period of liquidation, the company will not be a CIHC until the start of the next accounting period.

CTA 2010, s.34(5)

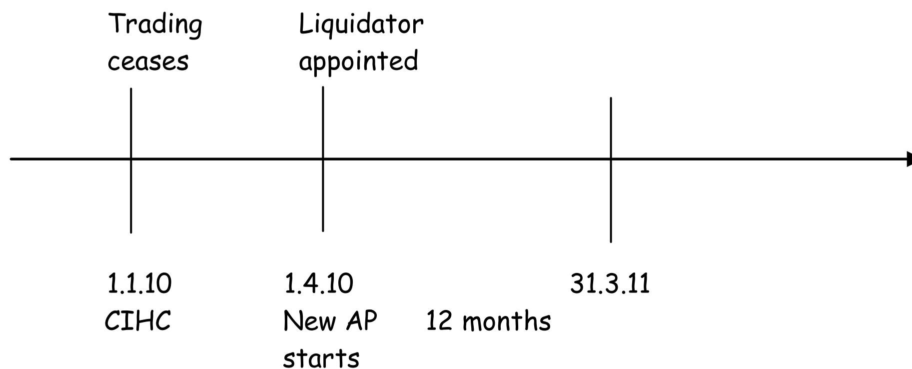
The effect of a company being classified as a CIHC is that it will pay corporation tax at the full rate of tax, currently 28%. The small company rate and marginal relief is denied to close investment holding companies.

Illustration 2

A close company is going to go into liquidation on 1 April 2010. If the liquidator is appointed while the trade is still being carried on, then the company will not become a CIHC until 1 April 2011.



However, if the trade ceased on 1 January 2010 and then the liquidator is appointed on 1 April 2010, the company will be a CIHC from 1 January 2010.



Example 1

Taking the facts from Illustration 1 above, assume Farcaso Ltd is a close company. When will Farcaso Ltd become a CIHC?

What difference would it make if Farcaso Ltd ceased to trade on 1 November 2009?

35.3 During the liquidation

If the liquidator continues to carry on the trade of the company then the normal rules apply, expenses will be allowable so long as they are incurred **wholly and exclusively for the purposes of the trade.**

CTA 2009, s.54

The expenses of the **liquidator** (their fees) will be allowable so long as they **relate to the trade.** The fees and expenses relating to the actual winding up of the company, being the sale of the company's assets followed by distribution to creditors and shareholders, will not be allowable as such expenses do not satisfy the 'wholly and exclusively' purpose test.

Once the company ceases to trade its income will be reclassified and it will no longer be able to get a trading deduction for expenses. **Post cessation receipts are taxable** and **post cessation expenses** can only be **deducted from these post cessation receipts**. Thus the cost of collecting debts should be taken into account when valuing assets at cessation and expenses accrued wherever possible.

CTA 2009, s.188 -190

CTA 2009, s.195 & s.196

At cessation of trade it is likely that the company will have **stock,** this will be treated as disposed of for **market value**. Likewise any **plant and machinery** held at the cessation date will be treated as disposed of for **market value.**

CTA 2009, s.162

Payments to redundant employees are allowed under CTA 2009 s.76. In addition, up to three times the statutory limit are allowed under CTA 2009 s.79(3). Thus a total deduction of 4 times the statuary limit is possible. The payments are treated as arising on the last day of the trade.

CTA 2009, s.76

CTA 2009, s.79

A company in liquidation is often a loss making company. When a loss making company ceases to trade, **relief** is available **for** these **trading losses** by:

- Offset **against total profits** before charges **of the loss making period**, and then
- **Carry back 3 years**, on a last in first out basis, against total profits before charges (terminal loss relief).

CTA 2009, s.39

Therefore it is advantageous for the company to realise chargeable gains prior to trade ceasing as this enables the trading losses to be used against the company's total profits, which include chargeable gains.

Alternatively, the trading losses may be group relieved to other members of the same group relief group.

Assets can be owned in two ways – legal ownership and beneficial ownership. Legal ownership is simply the name of the person registered on the deeds with regard to property or the registered owner of shares in respect of shareholdings. The beneficial owner is the person who has all the benefits of ownership. It is common for the same person to be both the legal and beneficial owner.

However, when a liquidator is appointed a **company loses beneficial ownership of its assets.** Thus if a parent company is in liquidation it will lose beneficial ownership of any shareholdings and hence any group relief groups formed via its share holdings will be broken from that date. Thus a company might consider a pre-liquidation reorganisation to ensure group relief is retained for as many group members as possible, notwithstanding that one of the group, possibly a former holding company, is being liquidated.

The **substantial shareholdings exemption** normally requires the investing company (i.e. the owner of the shares) to have beneficial ownership of its shares in the investee company. However, where the investing company goes into liquidation, it is still able to benefit from this exemption on a subsequent disposal of any qualifying shares it owns.

TCGA 1992, Sch 7AC Para 16

Capital gains groups are based on legal ownership of shares rather than beneficial ownership, thus the appointment of a liquidator **will not break the gains group.**

TCGA 1992, s.170

A degrouping charge does not arise if a company leaves a gains group as a result of another company ceasing to exist. **Thus liquidation of a parent will not cause a degrouping charge to arise in the subsidiary.**

35.4 Distributions

Distributions made before the liquidator is appointed is a straight forward dividend. For individual shareholders this will be taxable at their usual rate - for higher rate taxpayers this will be 32.5% plus 10% tax credit, for additional rate taxpayers this will be 42.5% plus 10% tax credit. For corporate shareholders the dividend will be franked investment income and not taxable.

However, distributions made during a winding up (after the liquidator has been appointed) are **capital not income,** thus the shareholder is treated as having made a disposal of his shares in return for the amount distributed.

If there is more than one distribution in the course of a winding up then each one is treated as a part disposal using the formula A/A+B.

This is an area where planning can be useful. If the company declares a dividend prior to the appointment of the liquidator, the shareholders will be treated as receiving an income distribution (i.e. a dividend) – taxable as above.

If the dividend is paid after the liquidator is appointed it will be a capital distribution. Entrepreneur's relief may be available (which reduces the capital gains tax payable to 10%, within certain limits) and the shareholder will be able to use their annual exemption.

For an individual to be able to **claim entrepreneur's relief** on a disposal of shares the individual must:

- have owned at least 5% of the share capital in the trading company, and
- been an officer or employee of the company

for a period of at least one year. Normally these conditions must be satisfied for at least one year prior to the date of the disposal of the shares. However, for companies in liquidation, the **one year** period is **up to the date that the company ceased to trade**.

Futhermore, entrepreneur's relief will only be available if the **share disposal takes place within three years of the company ceasing to trade.**

For a higher rate or additional rate taxpayer a capital gain would be more tax efficient than a dividend, even if entrepreneur's relief were not available.

Corporate shareholders, however, would prefer a dividend since companies are not taxed on UK dividends received, whereas they are subject to corporation tax on chargeable gains, although the substantial shareholding exemption may apply which would reduce any chargeable gain to nil. The company would need to have held at least 10% of the shares in the company for a minimum 12 month period and also satisfy various conditions before and after disposal – see further chapter 24.

Illustration 3

Siniestro Ltd pays a dividend of £30,000 to Jinny on 1 July 2009. The company appoints a liquidator on 1 September 2009, the winding up is complete and a final dividend is paid on 1 August 2010. Jinny receives £40,000.

Jinny is an additional rate taxpayer. She paid £1,500 for her shares. Jinny will have other gains that will use her annual exemption and is not entitled to entrepreneurs' relief.

The first dividend will give rise to dividend income for Jinny in the tax year 2009/10.

Gross dividend $30{,}000 \times \frac{100}{90}$	33,333
Income tax @ 42.5%	14,166
Tax credit	(3,333)
Income tax due	£10,833

The final distribution is capital in the tax year 2010/11. Jinny will have a capital gain of:

Sale proceeds	40,000
Cost	(1,500)
Chargeable gain	38,500
CGT @ 28%	£10,780

Example 2

Would it have been better in the above Illustration 3 for no dividend to have been paid on 1 July 2009 so that Jinny receives a final dividend of £70,000 on 1 August 2010?

35.5 Other tax implications of liquidation/administration

Corporation tax rates

Companies that are in liquidation/administration may make early self assessment returns in order to finalise their affairs based on tax rates applying in the previous tax year.

Loan relationships

The connected party rules do not apply to companies which have gone into liquidation as they are specifically overridden by the legislation. However, this override will only apply while the company remains in liquidation. Where the company comes out of liquidation as a result of these new insolvency provisions, the connected party rules will be reinstated as they were before.

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Answer 1

Farcaso Ltd will not be a CIHC until the accounting period beginning **1 December 2010.**

However, if Farcaso Ltd had ceased to trade on 1 November 2009 then there would be an accounting period from 1 November 2009 to 30 November 2009 during which it was not trading. It would be a CIHC for this accounting period and all subsequent accounting periods. i.e. from **1 November 2009** onwards.

Answer 2

If Jinny receives a final dividend of £70,000 she will not have the income tax liability of £10,833 in 2009/10 and her capital gains tax liability in 2009/10 will be:

Gain (as in Illustration)	38,500
Add additional proceeds	30,000
	68,500
Tax at 28%	£19,180
Tax paid previously (£10,833 + £10,780)	£21,613

Overall the tax bill is lower now and in addition the tax is paid later.

However we have only considered one shareholder. The position of a higher rate taxpayer would be different. Corporate shareholders may prefer to receive pre liquidation dividends as these are not taxable on companies. Capital proceeds may create a chargeable gain, subject of course to the substantial shareholding rules.