DEPENDENT SUBSIDIARIES: A PROBLEM OF DEFINITION

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Introduction

The dependent subsidiaries legislation, which forms part of the code for "unapproved employee share schemes" in FA 1988 ss.77-89 (referred to hereafter as "the new code"), contains many traps for the unwary.

The new code was published in draft form in an Inland Revenue press release issued on 26th October 1987, following a review of FA 1972 s.79 (the old code for unapproved employee share schemes, which contained wide-ranging anti-avoidance provisions). Under the old code, any growth in value in shares acquired by employees in a subsidiary company was, generally speaking, liable to be charged to income tax, even if there had been no deliberate tax avoidance. This was because neither of the two exceptions to the charge in FA 1972 s.79, the "majority test" (which required that the majority of shares of the same class must have been acquired otherwise then by employees or directors) and the "control test" (which required that the majority of shares of the same class must have been acquired by employees or directors, present or past, who as holders of the shares were able to control the company), could normally be satisfied in respect of shares in a subsidiary company.

In the 26th October 1987 press release the Inland Revenue announced that the Government accepted there was a genuine problem for any company that wanted to motivate employees and directors of a subsidiary company by offering them shares in that subsidiary. At the same time they pointed out the numerous opportunities for abuse, in particular the various ways value could be shifted into a subsidiary company, thereby benefiting the employee shareholders.

The result was the dependent subsidiaries legislation, announced as a "pragmatic solution" to the problem, designed to facilitate share acquisitions by employees in subsidiaries operating more or less independently of their group, while at the same time preventing possible abuse.

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The Charge to Tax

The charge to tax, on the growth in value of shares acquired pursuant to a right obtained by reason of employment, is broadly the same under the new code as under the old code. A person who is chargeable to tax under Schedule E Case I and who acquires shares in a company which is a dependent subsidiary will be subject to income tax under Schedule E (no case is specified) on any growth in value of the shares in the company on the earlier of:

(a) seven years from the time of acquisition; and

(b) the time when the person ceases to have a beneficial interest in the shares.

(FA 1988 ss.79(1)(2))

Similarly, where a person acquires shares as a result of an employment opportunity in a company which, although not a dependent subsidiary at the time of acquisition, subsequently becomes a dependent subsidiary, an income tax charge on any growth in value of shares will arise on the earliest of:

(a) seven years from the time that the company becomes a dependent subsidiary;

(b) the time when the person making the acquisition ceases to have a beneficial interest the shares; and

(c) the time when the company ceases to be a dependent subsidiary.

(FA 1988 ss.79(1)(3))

There are rules preventing a double charge to income tax and capital gains tax on a disposal (FA 1988 s.84).

What is a Dependent Subsidiary?

All 51% subsidiaries are dependent subsidiaries unless two conditions, referred to below as the "Business Test" and the "Value Test", are both met. A company is a 51% subsidiary if more than 50% of its ordinary share capital is owned directly or indirectly by another body corporate (FA 1988 s.87 and TA 1988 s.838). Whether or not the two conditions have been met is determined largely on the basis of self-certification. The directors of the principal company (the ultimate parent) must, within two years of the end of the relevant period of account, provide to the subsidiary's Inspector of Taxes a certificate stating that in their opinion the Business Test and the Value Test have both been met. The auditors of the subsidiary must also provide a report, addressed to the directors of the principal company, stating that they have enquired into the state of affairs of the subsidiary with particular regard to the Business Test and the Value Test and are not aware of anything to indicate that the directors' opinion is unreasonable in all the circumstances.

The Business Test

The first condition which must be met if a subsidiary is to fall outside the definition of "dependent subsidiary" is that:

> "the whole or substantially the whole of the company's business during the period of account (taken as a whole) is business carried on with persons who are not members of the same group as the company"
>
> (FA 1988 s.86(1)(a))

The wording of the Business Test is vague and unsatisfactory in a number of respects. In particular, "the whole or substantially the whole" and "business" are not defined, as one might expect; nor has the Inland Revenue published any guidance as to how the statutory provisions should be interpreted. A recently revised Inland Revenue publication, entitled "Share Acquisitions By Directors And Employees" (IR16), addresses the question of what is a dependent subsidiary, but does not in any way expand upon the statutory definition. From discussions we have had with the Inland Revenue it would seem that this is deliberate. The statute has been drafted so as to put the onus in determining whether or not a company is a dependent subsidiary on the directors of the principal company in the group and, but to a lesser extent, on the auditors of the subsidiary; nor are the tests which the directors and auditors must apply mechanical; a degree of judgment is involved. No doubt the Inspector may subsequently choose to review the position to determine whether or not he agrees with the directors' opinion, but prime responsibility rests with the directors. Indeed, there are some grounds for arguing that, if the directors have issued their certificate based on a reasonable interpretation of all the relevant terms, and the auditors have provided the necessary report, the Inspector is not in a position to challenge the directors' opinion.

On general principles "business" has a wider meaning than the mere carrying on of a trade. The business of an investment company consists of activities involved in the "making of investments" (TA 1988 s.130). For VAT purposes "business" means more than a trade, profession or vocation, encompassing for example clubs, associations and organisations (see VATA 1983 s.47).

Some commentators argue that a company's business is not just its trade, but all transactions that the company undertakes; thus "business" and "business carried on" would include all transactions which comprise the business, certainly those accounted for in the trading account (credits and debits) and probably (although less certainly) all items accounted for in the profit and loss account.

An alternative position is to say that only sales and purchases included in the trading account need be considered in determining whether "the whole or substantially the whole" of a company's business is to carried on with non-group members. Indeed, at one time the Inland Revenue appears to have held the view that "the whole or substantially the whole" of a company's business meant 90% of sales revenue, although this has never been stated officially and is probably not now the Revenue's position.

On this second interpretation a number of principles would follow.

(a) Trading income received by a trading company would clearly be business income.

(b) Investment income (including dividends from subsidiaries) received by an investment company would be business income.

(c) Investment income (excluding for the moment dividends from subsidiaries but including dividends from portfolio investments) received by a trading company would probably not be business income, except in the case of a financial trader such as a bank or insurance company where investment income (other than franked income and group income) is taxed under Schedule D Case I.

(d) Dividends received by a trading company from a subsidiary in circumstances where the activities of the two companies were connected, for example through operating in similar markets and sharing common management, would arguably be business income, although the position is not free from doubt. Dividends received by a trading company from subsidiaries without such connection would probably not be business income.

(e) Purchases from group companies accounted for as cost of sales would constitute business expenses. Other intra-group transactions, for example transfers of capital assets, group relief, ACT surrenders, interest on loans and so on, would be ignored.

This second interpretation has attractions, in that it is less all-embracing. Nor would it lead to certain advantage; any increase in the value of shares in a company arising because intra-group transactions have taken place at more or less than the market value would, if the value of the company increased by more than 5% of the value at the beginning of the period in question, be caught by the Value Test.

In the absence of a statutory definition of "business" and "the whole or substantially the whole" one must take a pragmatic view of the position. It is up to the directors to decide what the terms mean in the particular circumstances of each case, and for the auditors to determine whether or not the directors' opinion is reasonable.

The Value Test

The second condition which must be met is that:

> "during the period of account either there is no increase in the value of the company as a result of intra-group transactions, or any such increase in value does not exceed 5 per cent of the value of the company at the beginning of the period (or a proportionately greater or smaller percentage in the case of a period which is longer or shorter than a year)."

(FA 1988 s.86(1)(b))

"Intra-group transactions" means transactions between group members which are carried out other than on arm's length terms. There are special rules regarding payments for group relief (see below) (FA 1988 s.86(3)).

The Value Test is couched in terms of an increase in "the value of the company". Although "value" in relation to shares and benefits is defined in FA 1988 s.87, no specific guidance is given as to what is meant by the "value of the company". (Incidentally, the inclusion of the words "the person holding the shares" in FA 1988 s.87 means that determining growth in value requires a Schedule E valuation in which personal circumstances can be taken into account, see *Ede v Wilson* and *Ede v Cornwall* 26 TC 381, rather than a hypothetical buyer and seller valuation, as for CGT purposes.) As with the Business Test, in the absence of a statutory definition a pragmatic approach must be adopted. The Inland Revenue should accept any reasonable measure, provided that it is consistently adopted.

In the case of a listed company (and there are a number of listed companies which are 51% subsidiaries of other companies) market capitalization would appear to be an appropriate method of valuation.

In the case of an unlisted company (including a USM company) value should probably be established on normal share valuation principles, assuming a hypothetical willing vendor and a hypothetical willing prudent purchaser. The whole of the share capital is being valued so that a control premium should be included.

For the purposes of the Value Test intra-group transactions on arm's length terms and payments for group relief are ignored. The requirement that intra-group transactions should be on arm's length terms may be important for other reasons, for example, TA 1988 s.770, particularly where either the principal company or the subsidiary is non-UK resident.

Again a number of principles can be deduced.

(a) A dividend paid by a subsidiary to its parent is on the face of it an intra-group transaction. However, arguably in normal circumstances there can be no increase in value as a result of receiving a dividend from a subsidiary, as the value of the investment in the subsidiary is correspondingly reduced.

(b) Management charges are intra-group transactions and will need to be justifiable in terms of the services provided to fall within the exception.

(c) The reference to "payment for group relief" in FA 1988 s.86(3) is enigmatic. Presumably, the claim or surrender of group relief can be ignored for the purposes of the Value Test, whether or not payment is actually made.

(d) There is no equivalent exemption for ACT surrenders, which must therefore be paid for at a rate corresponding to the tax saved or else be counted as "intra-group transactions" for the purposes of the Value Test.

(e) Similarly, intra-group asset transfers (taking into account any resulting deferred tax adjustment) must be paid for at an arm's length price, and debt finance must be provided at arm's length rates of interest.

The Directors' Certificate

I have already explained that the legislation is drafted in such a way as to put the onus in determining whether or not a company is a dependent subsidiary on the directors of the principal company in the group and, but to a lesser extent, on the auditors of the subsidiary. The directors of the principal company must take a view as to what is meant by "business", "substantially the whole" and "value" in the specific circumstances of a particular case. Provided that the directors' opinion is based on what, in all the circumstances, is a reasonable interpretation of the relevant provisions, there is no reason why the directors' certificate should not be issued and the auditors should not give a positive opinion.

The Audit Requirement

The auditors' report required by FA 1988 s.86(1)(d) is somewhat limited in scope. It merely requires the auditors to certify that they have enquired into the state of affairs of the company with particular reference to the Business Test and the Value Test, and to confirm that they are not aware of anything to indicate that the opinion expressed by the directors of the principal company is unreasonable in all the circumstances. The auditors are not required to make any more positive statement to the effect that, in their view, the company is not a "dependent subsidiary".

In practice, of course, the auditors may be required to take a more active role in advising the directors of the principal company on the application of the dependent subsidiaries legislation. The directors of the principal company may require detailed advice from the auditors of the subsidiary before issuing the directors' certificate.

Conclusion

In short, the dependent subsidiaries legislation is unclear in a number of respects; in particular, a number of critical definitions are missing. Given this, the directors of the principal company are entitled to make up their own minds on the meanings of the words "business", "substantially the whole" and "value of the company" and to interpret the legislation accordingly. Provided that the auditors have made enquiries into the affairs of the company and are not aware of anything to indicate that the directors' opinion is "unreasonable in all the circumstances", then there is no reason why the auditors' opinion should be qualified or withheld. If both certificates are issued then, given the lack of clear definition, the Inland Revenue will have the burden of proof working against them if the matter goes to court.