Time to Close off on Close Company Surcharge

by Mark Lonergan

Revenue has recently announced the implementation of temporary measures in relation to the close company surcharge regime, in response to the coronavirus pandemic.

The close company surcharge applies on the income of close companies that is not distributed within 18 months from the end of the accounting period in which the income arose. The surcharge is 20% of the excess of the sum of the distributable investment and estate income of an accounting period over the distributions for that period. In addition, a 15% surcharge can apply on certain undistributed income of close service companies.

Revenue have said that where a distribution is not made within that time as a result of Covid-19 circumstances affecting the company, Revenue will extend the 18-month period for distributions by a further nine months. Affected companies should apply to Revenue for an extension.

This measure will apply for accounting periods ending from September 30, 2018, onwards, and for which distributions to avoid the surcharge would be due by March 31, 2020, onwards.

If by the end of this extended period a distribution that can be made is not made, then the resulting surcharge will be included in the corporation tax liability for the 12-month accounting period following the surcharged accounting period as normal and interest will apply to the late payment of the surcharge.

This is all very welcome but perhaps we need to open a more general debate on close company surcharges per se.

Irish law allows many professionals to provide their professional services through limited liability companies. The incorporation of professional practices - be it dentists, doctors or accountants - has been a feature of Irish commercial life for the past 10 years. The catalyst for this change has been the change in the regulatory landscape for these professions, permitting such a change and also the need for professionals to join together to share costs and enjoy economies of scale. To take one example, dental equipment now runs into six figure sums, meaning that operating as a sole dental practitioner is not economically feasible.

Tax law has not kept pace. In fact, it is stuck in a 1970's time warp.

Tax law penalises the retention of undistributed income in closely held professional service companies. This is part of the suite of tax-avoidance measures introduced in the early seventies to combat perceived tax avoidance by smaller companies.

The pitfalls were highlighted in TAC determination (108TACD2020) published on 8 May 2020. This determination considered the operation of the surcharge on undistributed income of an accounting firm providing audit, accountancy, tax advisory, tax compliance and bookkeeping services.

The case concerned an appeal by the firm against amended notices of assessment raised by the Revenue Commissioners, seeking to impose a professional service close company surcharge on the profits of the company, for the years ended 30 April 2012 and 30 April 2013. The appellant argued that the principal part of the Company's income derived from the provision of bookkeeping services and accordingly did not derive from the carrying on of a profession or the provision of professional services.

The view of the Irish Revenue Commissioners was that s441 Taxes Consolidation Act 1997 applied to all the firm's income, as all the income was professional income and therefore sought to impose a professional services surcharge for the years to 30 April 2012 and 30 April 2013 and amended notices of assessment were issued for the two years with total additional tax payable of €97,253, including related 10% late filing surcharges.

The Appeal Commissioner agreed with Revenue. He noted that it is not possible to examine different parts of a composite professional service in isolation and then classify portions of the final service as non-professional.

The Appeal Commissioner indicated that the intention of the close company surcharge legislation is that Parliament wishes companies carrying our professional services to be required to distribute a specified amount of profits within a specified period of time or else suffer a surcharge.

The determination that was issued related to an appeal against assessments that were raised in connection with the operation of

the surcharge on undistributed income of service companies (i.e. the professional services surcharge).

The appeal was determined in favour of the Irish Revenue Commissioners and it was concluded by the Appeal Commissioner that the amended notices of assessment issued were correct.

Appeal commissioner decisions are not legal precedents but rather confined to their own facts and, in any case, the close company rules are vulnerable to legal attack on a number of grounds.

These grounds are the following:

Difficulty with the meaning of "Profession"

The word profession is not defined in tax law. This is a fundamental issue. The Revenue, in their tax briefing 48, have adopted what can only be described as a crude list system. However, taking a list of almost every occupation, outside of manual work, and designating all of them a "profession" is wide off the mark and is not correct in law.

Simply listing an occupation as a profession in a tax briefing surely cannot give Revenue carte blanche to impose a close company surcharge. A profession as a legal term surely should have a more exacting legal test than a list. Curiously, a pharmacist (whom the vast majority of public would consider a profession) is not considered so by virtue of an obscure 1950s case on restricted practices. In contrast, the Revenue state that Auctioneer/Estate Agent is a profession.

Indeed, the argument could be made that the concept of a profession is no longer relevant. The modern world is one of business/trade. Is the idea of an avuncular accountant poring over a ledger, quill in hand, after a leisurely lunch, outmoded? The modern accountancy firm is one of multi-disciplinary teams, budgets, and marketing departments and run very much as a trade/business.

As far back as 1965, Rex Mackey SC (a customs expert in his youth), wrote in his Windward of the Law that the Irish bar was taking an inexorable decline from a profession to a trade.

All professions are businesses first and foremost.

Corporation Tax Rate

12.5% is the stated rate for trading profits of Irish companies. This is enshrined in legislation and was the subject of extensive negotiations at EU level to agree some twenty years ago. It seems very unfair that this headline rate is the sole preserve of the large company.

Discrimination – Freedom of Establishment

Freedom of establishment is a cornerstone of EU law. The close company surcharge rules discriminate against smaller professional practices.

If you have an accounting firm with, say, 10 participators/partners, the rules do not apply. In contrast, if you have a smaller firm with 3 participators/partners, the full surcharge will be imposed on any undistributed cash. This cannot be correct.

Proportionality

This is a very important doctrine which has its basis in German Law and has been imported to Irish Law by means of general principles of European Law. It has been applied in numerous tax cases, most notably Daly v Revenue Commissioners, [1996] 1 ILRM 122

There is also a significant corpus of law from the EU court, the European Court of Justice. Proportionality is now a fundamental precept of European law under Article 3(6) of the EC Treaty added by the Treaty of European Union. In European law, in order to be compatible with the principle of proportionality, a measure must be appropriate and necessary to achieve its objectives.

The principle is viewed as an important concept, based on the premise that the law must serve a useful purpose, and one which underpins liberal democracy. In German law, it is a fundamental principle known as Verhaltrismansigkeit.

Is close company surcharge a penalty?

There is considerable case law on the definition of a penalty and, more importantly, who has the power to impose a penalty. In short, the law frowns on penalties – this can be seen in contract law jurisprudence where penalty clauses in contracts are regularly struck down as void. Penalties, if they are to be imposed, should be imposed by a judge in accordance with the law and not by Revenue.

Insolvency/Capital Maintenance rules.

Capital maintenance rules are fundamental to the protection of creditors of a company in Company law. Cash management is an essential component of the effective and prudent management of a company's finances.

Tax rules which effectively force companies to extract cash from their balance sheet can hardly be said to comply with these rules. It is hardly desirable to have tax laws which encourage profligacy.

Company—Carrying on a profession

There is interesting case law as to whether a company can carry on a profession. A company is in effect an abstraction. Shipwright in his Textbook on Revenue Law cites the case of William Esplen Son and Swaniston v IRC 1919 2KB 731 as authority that a company cannot carry on a profession.

Conclusion

Perhaps the last word should go to the Commission on Taxation Report 2009 (which stretches to 561 pages!). Under the heading "Supporting Economic Activity", the following recommendation appears:

Our investigation of ways to support economic activity and grow employment is based on a pro-business ethos. The close company surcharge on professional services companies inhibits such companies from re-investing their trading income. Similar restrictions do not apply to other trading companies. We cannot see an objective rationale for distinguishing between professional services companies and other trading companies and we therefore recommend the abolition of the surcharge for professional services companies.

In short, the close company surcharge should be abolished and the playing field levelled. It is least that the SME sector deserve.

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