

# Capital Dividends - An Update

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In my article published in Tax Journal on 1 February, I described how HMRC was arguing that certain dividends and other distributions were “of a capital nature” and therefore fell outside the scope of the corporate dividend exemption in CTA 2009 Part 9A, which was introduced in July 2009.

### The ministerial statement

Over the last few weeks there have been intense discussions between HMRC, tax advisers and business on this issue, with HMRC being made aware that the position that it was taking was causing considerable uncertainty in what is a crucial area of tax law for UK companies. On 24 February, Stephen Timms made a ministerial statement to the effect that legislation will be introduced in the Finance Bill to restore previous expectations as to the tax treatment of distributions for corporate recipients.

Whilst there are no details of the legislation in the statement, it is understood that its effect will be to provide that all distributions made by a UK resident company are income in nature, unless there is a specific rule to the contrary. This will presumably mean that the tax treatment of share redemptions will be confirmed to be as previously understood: that that part of the amount paid on a redemption of shares by a UK company that is a distribution as defined in ICTA 1988 s 209 is income in nature and is therefore not brought into account for CGT purposes due to TCGA 1992 s 122(5)(b).

More importantly, dividends paid out of distributable reserves that have previously been created on the cancellation of share capital will not be treated differently from dividends paid out of other distributable reserves. This will be a great relief for the many companies which have created distributable reserves in this way.

It should be noted that, although this only affects the tax treatment of corporate shareholders, not income taxpayers, it presumably will bring the two regimes into line on this point. The income tax provisions already provide that distributions from a UK company are always treated as income in nature (ITTOIA 2005 s 383).

The statement is silent on the tax treatment of distributions paid by non-UK resident companies. In the absence of any new legislation for non-UK distributions, their tax treatment would continue to be different depending on whether the distribution is income or capital in nature. This again mirrors the income tax provisions, where ITTOIA s 402 provides that dividends paid by non-UK resident companies are not subject to income tax if they are capital in nature.

The changes are to apply retrospectively “where appropriate” although to avoid any complaint of taxation by retrospective legislation it will be possible for companies to “opt out” of the new legislation so as to ensure it does not increase their tax liabilities.

### CGT implications

It is clear that one of the reasons for HMRC’s recent position was a concern that companies that did not qualify for the substantial shareholding exemption from CGT in respect of their shareholdings would seek to structure what would otherwise be capital receipts as tax exempt dividends under the new regime.

This is, of course, not a new issue, and the capital gains tax code already contains much protection for HMRC in both the value shifting rules in TCGA 1992 s 30 and the depreciable transaction rules in TCGA 1992 s 176. The existing

rules do, however, have their limitations: the depreciable transaction rules only ever reduce or eliminate capital losses and the drafting of section 30 is complicated and prescriptive, and therefore both catches situations which it should not, and also does not apply to situations which arguably should be within its scope.

HMRC seems to have accepted that it is not appropriate to tackle their capital gains tax avoidance concerns via the dividend exemption, but rather should fix the CGT regime. Indeed, in the recently published HMRC consultation document entitled "Simplification review – capital gains tax rules for groups of companies" HMRC is proposing to replace the value shifting rules in many situations with a targeted anti-avoidance rule that would apply where there have been arrangements that reduce the value of shares and a main purpose of these arrangements is to obtain a corporation tax advantage.

### Next steps

The ministerial statement is helpful, but we will not know the exact position until the draft legislation is published. Until then, a residual uncertainty remains on the tax treatment of affected dividends, and companies might well decide either to delay the payment of relevant dividends or to seek further clarification on their specific circumstances.

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