Returns of Value – Tax Issues

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The ongoing global economic uncertainty has resulted in many groups that have successfully navigated the recessionary storm holding significant surplus cash. In the absence of prudent investment opportunities, these groups have been increasingly pressured to return this cash to shareholders disappointed with low returns on equity.

Cash is usually returned to shareholders by way of a special dividend, a tender offer (or share buy back) or a so-called B share scheme. Similar results can be achieved using a reduction of capital or a scheme of arrangement but, while having the advantage of not requiring distributable reserves nor incurring stamp duty, these methods have proven less popular as both take longer and/or require court approval. This article therefore focuses on the most common ways for groups to return cash to shareholders and the key tax issues to bear in mind when choosing between them.

INCOME OR CAPITAL?

The most important tax consideration when returning cash to shareholders is whether that return will be treated as an income distribution or a return of capital for UK shareholders (see summary box). For UK shareholders, a return of capital is treated for capital gains purposes as a part disposal of the shares in the company returning value while a distribution is taxed as income. Whether a company wishes to provide its shareholders with income, capital or a choice between the two will often dictate the form the return of value takes.

Higher and additional rate income taxpayers will usually prefer to receive capital because the combination of base cost in the relevant shares for CGT purposes, the CGT annual exempt amount, any capital losses and lower rates are likely to mean a lower tax burden. By contrast, UK resident corporate shareholders and basic rate income taxpayers would usually prefer an income distribution on the basis it is exempt (corporates) or any tax liability is covered by the tax credit (individuals). Pension funds, charities and individual shareholders who hold shares in an ISA are usually indifferent for tax purposes between a repayment of capital and an income distribution.

SPECIAL DIVIDEND

A special dividend is the simplest way for a company to pass surplus cash to shareholders as it is usually just an interim dividend, albeit a large one. This does mean that, as with normal dividends, the entire amount will be treated as income for UK tax purposes. There are no stamp tax concerns, shareholders share in the dividend in
proportion to their holdings in the company returning cash and, if the dividend is paid as an interim dividend, there is generally no requirement for shareholder approval.

‘GOOD TAX CAPITAL’

Any payment out of the assets of a company to its shareholders will be an income distribution for UK tax purposes save to the extent that that payment represents a repayment of capital on the shares or is matched by new consideration provided by the shareholders. Following the Noved decision ([2006] STC 120) there was some uncertainty as to whether a return of value needed to be structured as a repayment of capital, made for new consideration or both. The uncertainty arose from the fact that ICTA 1988 s209(4) (now CTA 2010 s1020 and which was held in Noved to be capable of applying to cash payments) had no exclusion for repayments of capital. But many practitioners considered Noved to be wrongly decided and were concerned that if a return of value did not need to be a repayment of capital that would undermine ICTA 1988 s211 (now CTA 2010 s1026), which provides for certain distributions following bonus issues paid up otherwise than for ‘new consideration’ (paid up out of distributable reserves, say, rather than share premium) not to be treated as repayments of capital. FA 2012 has removed the uncertainty here by providing (in CTA 2010 s1020(2A)) for anything which is a distribution under CTA 2010 s1000(1)B (or which would be such a distribution but for its being a repayment of capital) not to be a distribution under CTA 2010 s1020. Consequently, if a company now wants to provide its shareholders with a capital return it is clear that ensuring that it is treated as a repayment of capital will suffice.

So what is a repayment of capital for these purposes? It is basically any return to shareholders of ‘new consideration’ originally provided for the shares (i.e. the amount originally subscribed for them, including any share premium). Such amount is often referred to as ‘good tax capital’.

The process of establishing the amount of good tax capital can be time consuming for anything other than a new holding company (and inserting a new holding company is one technique that can be used to create good tax capital equal to the current market value of the group). A company’s good tax capital should include the amount originally subscribed for the shares. However, the distribution rules in CTA 2010 Part 23 mean that the company must also consider any transactions that may have used up (or added to) the good tax capital, including employee share schemes or past bonus issues. Bonus issues paid up from distributable reserves, including stock dividends, can, in particular, limit the amount of good tax capital available for a return of value.

TENDER OFFER OR SHARE BUY BACK

Many listed companies have ongoing share buyback programmes. These programmes are not generally suitable for larger returns of value, however, as they are usually restricted in size to ten or fifteen per cent. of the company’s share capital by the UK listing rules or the authority granted by shareholders at the most recent AGM and may have to be suspended during close periods.

For a larger return of value, therefore, a more formal tender offer may be required. There are broadly two ways to implement this.

The first is to repurchase shares directly from shareholders. Unless the company in question has an unusually high amount of good tax capital per share, this method normally results in a significant proportion of the amount returned constituting an income distribution where the shares are repurchased for more than their original issue price.
The second option is to use an intermediary (usually a bank). This involves the intermediary making an offer as principal to the company’s shareholders to purchase their shares and then the company purchasing those same shares from the intermediary. There is usually significant commercial pressure to ensure that this repurchase by the company happens very shortly after the purchase by the intermediary (not least to ensure the intermediary is not left holding a substantial proportion of the company’s shares and, in the case of a large tender offer, is able to obtain a waiver from the Takeover Panel for any requirement to make a bid for the entire company!). The company and intermediary therefore often enter in to cross options that allow the company to call for the shares and the intermediary to put the shares or a full repurchase agreement. To ensure the selling shareholders receive capital treatment, however, it is critical that the intermediary is genuinely acting as principal.

With either option, the only stamp duty charge should be on the purchase by the company of its own shares. When using an intermediary it should be possible to rely on the intermediaries’ exemption to avoid a stamp duty or SDRT cost on the purchase by the intermediary. The intermediary should give representations to the company confirming it meets the conditions for that exemption.

There are two main drawbacks with the tender offer route. Firstly, it only returns cash to those shareholders who accept the tender offer. This means that there may be shareholders who miss out or who end up with a larger percentage holding in the company and indeed there may not be sufficient acceptances for the company to complete the return of value. Secondly, it does not offer shareholders a choice of income or capital. To deal with both these concerns, more sophisticated returns of value often use B share schemes.

**B SHARE SCHEME**

B share schemes are so-called because they involve the company issuing one or more new classes of shares, which are called B shares (or sometimes C shares) to distinguish them from the company’s ordinary shares. B share schemes can be used to return income, capital or both.

Historically, B share schemes were just used to return cash as capital. This is done by issuing redeemable B shares that are paid up using ‘good tax capital’ and then redeeming those shares. If there is insufficient good tax capital, then non-redeemable B shares can be issued and purchased by an intermediary in the same way as a tender offer. Stamp duty will be payable on the repurchase transaction (but not a redemption) and, if the B shares are unlisted, on the purchase by the intermediary too (requiring an assessment as to whether or not the second slug of stamp duty would be higher or lower than the costs of listing the B shares). Alternatively the B shares can be issued by a new holding company (the new consideration for the issue of the B shares and the ordinary shares in the new holding company being the receipt of shares in the old holding company). Unusually in the 2011 Aggreko B share scheme, Aggreko was able to split its existing ordinary shares into new ordinary shares and B shares as a result of its earlier demerger from Christian Salvensen leaving it with a large amount of good tax capital.

More recently B share schemes have been used to allow shareholders to elect whether to receive their cash in capital or income form. This is now usually done by issuing shareholders with either redeemable B shares for a capital return or C shares for an income return depending on an election made by the shareholder. The B shares are paid up out of share premium with a nominal value equal to the capital to be returned and are then redeemed for that amount (redemptions at a premium would give rise to an income distribution and a repurchase would give rise to stamp duty). Some structures provide for multiple redemption opportunities allowing shareholders to split gains across multiple tax years. The C shares have a low nominal value (to avoid wasting good tax capital) and carry a right to a dividend equal to the amount to be returned. Once the dividend on the C shares is paid the C shares become worthless deferred shares that are cancelled or repurchased.
Though the share issue mechanics need to be considered carefully to ensure a CGT rollover, the more complex B share scheme therefore gives the greatest flexibility when returning cash to shareholders.

OTHER PRACTICAL POINTS

It is common for a return of value to be accompanied by a share capital consolidation, so as to maintain the share price at the same level as before the return of value (for comparison purposes, earnings per share ratios or share option plans). This should be a tax neutral reorganisation for UK shareholders.

A return of value may also be complicated by non-UK shareholders or tax rules. Overseas securities rules, for example, may oblige the company to compel certain shareholders to take income rather than capital and the choice of intermediary or paying agent may be complicated by non-UK rules, such as US backup withholding.

SUMMARY

Any return of value has to consider the tax consequences for both shareholders and the company concerned and in particular the split between income and capital treatment. This will require a thorough assessment of the good tax capital and distributable reserves available. Though more complicated than a special dividend or tender offer, the B share scheme route usually offers the greatest flexibility and choice for shareholders and the company.

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ANTI-AVOIDANCE CONCERNS

Companies (and their advisors) traditionally worried about the possible application of the transactions in securities rules when contemplating a return of value. Although occasionally clearances were obtained from HMRC under ICTA 1988 s707 the more common approach was for the company to obtain advice from leading Counsel (sometimes as to whether the technical requirements for a prescribed circumstance to be present were met but more often simply that shareholders ought to be able to rely on the exemption for transactions effected for “bona fide commercial reasons” without a ‘tax advantage’ main object) and then to tell shareholders that, on the basis of advice received, it did not expect those rules to apply. Neither of the authors is aware of these rules ever having been applied to a return of value undertaken by a listed company.

These rules have been rewritten and revised for both income tax (ITA 2007 Part 13) and corporation tax (CTA 2010 Part 15). Following their revision, these rules should not now be an issue for return of value transactions for individual or corporate shareholders (assuming the company returning value is not a “close company”, which a listed company should not be). Though the conditions in Circumstance C (CTA 2010 s736) could technically still be present for corporate shareholders, it is difficult to see how such a shareholder could in fact obtain a “tax advantage”. If income received is untaxed then this is a result of the specific dividend exemption rules and so should not be a “tax advantage”. If there is a bad motive and a capital loss is generated then TCGA 1992 s16A should apply to disallow the loss rather than the transactions in securities rules.

It will certainly be necessary for anyone contemplating a return of value to keep one eye on the development of the GAAR. In its currently proposed form the GAAR may cause some uncertainty in this area. If the relevant arrangements were considered to have a main purpose of achieving a tax advantage they would need to be tested against the rather vague double reasonableness test although one would hope, given the long history of such transactions and their fundamentally commercial nature (the desire to get underutilised cash back into shareholders hands), they would pass. Given that, in the authors’ view, even transactions which offer shareholders a choice of tax treatment sit firmly in the centre ground of responsible tax planning, it is to be hoped that the non-applicability of the GAAR to such transactions will become clearer in due course.
## Summary of Return of Value structures

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<thead>
<tr>
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<th>Shareholder UK tax treatment</th>
<th>Stamp duty/SDRT (assuming UK issuer)</th>
<th>Other considerations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Special dividend</td>
<td>Income</td>
<td>None</td>
<td>Usually no shareholder approval needed</td>
</tr>
<tr>
<td>Tender offer</td>
<td>Capital (up to good tax capital) and income for excess</td>
<td>0.5%</td>
<td>Special resolution required</td>
</tr>
<tr>
<td>Tender offer with intermediary</td>
<td>Capital</td>
<td>0.5%</td>
<td>Special resolution required</td>
</tr>
<tr>
<td>B/C share scheme</td>
<td>Flexibility for shareholders</td>
<td></td>
<td>Special resolution required</td>
</tr>
<tr>
<td>• redemption of B shares</td>
<td>Capital</td>
<td>None</td>
<td>B shares paid up with good tax capital</td>
</tr>
<tr>
<td>• purchase of B shares using intermediary</td>
<td>Capital</td>
<td>1% or 0.5% if B shares listed</td>
<td></td>
</tr>
<tr>
<td>• dividend on C shares</td>
<td>Income</td>
<td>None</td>
<td></td>
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