Can a dividend be capital in nature?

Sara Luder, Partner

When a shareholder receives a dividend, that receipt is income in nature in the hands of the shareholder, because a dividend by its very nature is fundamentally income in nature.

Many tax advisers might have agreed that this is a fair summary of the position under UK tax law, but a number of recent developments have raised concerns as to whether HMRC shares this view. The recent decision of the First Tier Tax Tribunal in First Nationwide v The Commissioners for HMRC (in which Sara acted for the taxpayer) therefore makes for interesting reading.

The Facts of First Nationwide
The taxpayer company entered into a stock loan with a bank under which it acquired certain preference shares in a Cayman company. The rights attaching to the preference shares were such that they carried an entitlement to two large quarterly dividends and thereafter the dividend right reduced significantly (although the shares were still worth at least £1m).

Immediately after acquiring the preference shares, the taxpayer sold these shares outright to a third party and it was therefore this third party (which was not subject to UK tax) who received the two dividends. Under the terms of the stock loan, however, the taxpayer was required to pay manufactured dividends in respect of these dividends to the bank. The taxpayer claimed a deduction for these manufactured dividends as a management expense under Schedule 23A ICTA.

The taxpayer still needed to satisfy its obligation to redeliver the preference shares to the bank under the stock loan, so it entered into a subscription agreement with the Cayman company entitling it to subscribe for replacement shares at a price that was equivalent to their market value and did subscribe for those shares after the two large dividends were paid.

The Dividend Argument
In challenging the tax treatment of the transaction, HMRC argued that the two large dividends were not “overseas dividends” for the purposes of Schedule 23A because either:

i. although they were lawful “dividends” for the purposes of Cayman company law, they were not dividends as that word should be construed for the purposes of Schedule 23A; or

ii. they were not income in nature (and therefore were not taxable under Schedule D, Case V) due to the fact that the dividends were paid (and indeed, the articles of the Cayman company required the dividends to be paid) out of the company’s share premium account rather than out of distributable profits. (It had been agreed that, in order to be overseas dividends, the dividends had to be in income in nature.)

The Tribunal Decision
On the first point above, Judge Berner was not persuaded that “dividend” should be given any special meaning in the context of Schedule 23A. The concepts underlying Cayman company law were analogous to those under English law and therefore the payments were dividends for this purpose. Indeed, Judge Berner went further and concluded that under Cayman law share premium is a form of distributable profit and therefore these dividends were a payment of part of the profits of the Cayman company.
Turning to the second point, Judge Berner reviewed the key cases in the area, including *IRC v Reid’s Trustees* [1949] AC 361, *Rae v Lazard* 41 TC 1, and *Courtaulds Investments Ltd v Fleming* 46 TC 111, and concluded that, following the payment of the dividends, the corpus of the shares was still intact, and that therefore the dividends were income in nature and “overseas dividends” for the purpose of Schedule 23A.

**So why is this decision of such current interest?**

The corporate dividend exemption in Part 9A CTA 09, which was introduced in July 2009, is expressed not to apply to distributions that are “of a capital nature”, due to Section 931A(2) CTA. By implication, therefore, there is a category of payments that are distributions as defined in Section 209 ICTA but, if received by a UK company, are taxable not under the Part 9A regime, but rather under the capital gains rules.

By contrast, the old Section 208 ICTA exemption applied to all distributions made by a UK company that fell within the definition of Section 209 ICTA. Previously, therefore, it was necessary to consider whether a distribution was income or capital in nature only where the distributing company was not UK resident. Part 9A, however, applies to distributions paid by both UK and non-UK resident companies.

Interestingly, the previous position is preserved for individual shareholders, as the income tax provisions still make a distinction between distributions from a UK company (which are always treated as income in nature by Section 383 ITTOIA) and dividends paid by non-UK resident companies (which are not subject to income tax if they are capital in nature, due to Section 402 ITTOIA).

As can be seen, HMRC argued in *First Nationwide* that a dividend paid out of share premium account is capital in nature. This is, of course, only going to be relevant for dividends paid by companies incorporated outside the UK (as UK companies are not permitted to pay dividends in this way), but what other types of distributions might be argued to be capital in nature?

**Share redemptions**

On a share redemption, the corpus of the asset disappears and, therefore, it would seem to be reasonably easy to conclude that this is a capital transaction for tax purposes.

For many years, however, HMRC have accepted (see Paragraph 58655 of the HMRC CGT Manual) that that part of the amount paid on a redemption of shares by a UK company that is a distribution as defined in Section 209 ICTA is income in nature and is therefore not brought into account for CGT purposes due to Section 122(5)(b) TCGA. There was, therefore, a distinction between the tax treatment of a corporate shareholder on a redemption of shares (where only the amount that was not treated as a distribution was brought into account for CGT purposes) and a share repurchase (to which Section 122 did not apply, and therefore where the entire amount received was included in the CGT computation).

It appears, however, that HMRC no longer holds this view, but instead believes that the tax treatment of a redemption should be the same as a repurchase, because the distribution element is capital in nature. While the consequences of this change will probably not be of any great concern, what is a concern is the uncertainty created until the position is clarified.

**Dividends paid out of distributable reserves created on the cancellation of share capital**

When share capital is cancelled and credited to distributable reserves, is a dividend paid out of the reserves so created capital in nature (because it is simply returning to shareholders the amounts they originally subscribed for the shares)?

This is something that is permitted under English company law and, indeed, many listed companies have as a matter of good corporate housekeeping created distributable reserves in this way as part of other larger transactions. In many cases, it will be impossible to identify the distributable reserves created in this way, which will have been credited to a single fungible account. This adds further weight to the argument that, once credited to distributable reserves, and possibly subject to any Ramsey-type argument, there should be no distinction between dividends paid out of reserves created in this way and other dividends.

It has become apparent over recent months that, prior to the *First Nationwide* decision at least, HMRC considered that dividends paid out of reserves created in this way are likely to be capital in nature in the hands of UK corporate
shareholders and therefore outside the scope of the corporate dividend exemption. In particular, HMRC had refused to give clearances that dividends paid out of distributable reserves created on the cancellation of share capital would fall within the dividend exemption.

As a matter of tax policy, this does seem to be a surprising stance for HMRC to take. First, this is an important area of law for business and one where the tax treatment needs to be certain. Second, if, as a policy matter, it is felt that certain distributions made by UK resident companies should be taxed as capital receipts, then why should the position for income tax payers be different? Lastly, it is hard to see how material amounts of tax could be at stake, given the availability of the substantial shareholding exemption and the ability of shareholders to structure transactions within the rules (once they know what those rules are).

The Repo Argument
For completeness, I should mention HMRC’s second argument in First Nationwide. This was that the sale of the preference shares to the third party, when combined with the taxpayer’s rights under the subscription agreement, amounted to a repo, and therefore the taxpayer was deemed by Section 737A ICTA to receive an amount equivalent to the two dividends. The argument here turned on whether, for the purposes of Section 737A, "purchase" includes a subscription.

The only relevant authority in this area is Re VGM Holdings Ltd [1942] 1 Ch 235, where Lord Greene said that "the difference between the issue of a share to a subscriber and the purchase of a share from an existing shareholder is the difference between the creation and the transfer of a chose in action….quite different in conception and result."

It was generally accepted by practitioners that VGM made it clear that a subscription was not a sale or purchase for the purposes of the repo rules and, indeed, there is also a statement broadly to that effect in an HMRC technical note published at the time of the rewrite of the repo provisions. It is therefore comforting to know that Judge Berner agreed with this analysis, and that, therefore, the repo rules did not apply to this transaction.

Summary
Given the recent uncertainties surrounding HMRC’s view of the application of the corporate dividend exemption to certain dividends, the decision in First Nationwide is timely, and it is to be hoped that Judge Berner’s very helpful analysis of the relevant law will enable some certainty to be restored in this important area.

This article was originally produced for the 1 February 2010 issue of the Tax Journal.