THE CITY OF LONDON LAW SOCIETY

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Andrew Page
HMRC
100 Parliament Street
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By email: andrew.page@hmrc.gsi.gov.uk

Dear Mr. Page

Re: Dividends paid following reductions of capital

I am writing on behalf of the Revenue Law Committee of the City of London Law Society. We understand that HMRC may be taking the view that dividends paid out of reserves created on a reduction of capital are taxable as capital gains rather than as income.

This issue is of great importance to companies and their shareholders, and potentially has very significant compliance implications. Public companies frequently reduce capital in order to create distributable reserves so that they can continue to pay normal levels of dividends to their shareholders. Reductions of capital are particularly common where there has been a merger or demerger resulting in a new parent company being created with little or no reserves. Such a company will need to create reserves in order to be able to pay normal levels of dividends following the merger or demerger. It cannot simply rely on dividends received shortly after the transaction from its subsidiaries to create distributable reserves because the reserves created by such dividends are likely to be matched by an impairment charge for the reduction in value of the subsidiaries following the payments of the dividends.

Reductions of capital are also frequently undertaken within groups of companies in order to remove “dividends blocks”, intermediate holding companies with deficits on reserves which would mean that dividends cannot be paid through them by their subsidiaries to their parent companies.

The general understanding among advisors has until very recently been that dividends paid out of reserves created on a reduction of capital are income in nature and attract the normal tax treatment afforded to dividends paid out of income profits. This has been the generally understood position for many years and we are not aware of HMRC challenging the position before the introduction of the new exemption for corporate dividends.

We consider that it is of the utmost importance that the generally understood treatment of transactions should not be disturbed without full consultation. We also consider that it is in the general interest of tax payers and HMRC to avoid changes which would have significant compliance implications.

We understand that HMRC's views are based on two arguments:-

(a) A dividend paid out of reserves arising on a reduction of capital may not be a dividend or distribution falling within section 209(2)(a) or (b) ICTA 1998 because it is not paid out of "profits" and represents a repayment of capital; and

(b) where such a dividend is received by a corporation tax paying company, it may be of a capital nature so that the charge to income and the exemption in Part 9A CTA 2009 does not apply.

As regards the first argument, we consider that "dividend" in section 209(2) (a) has the same meaning that it bears for company law purposes. As a matter of company law, dividends can only be paid out of profits available for the purpose and must not be paid out of capital (sections 830 and 851 Companies Act 2006). Assuming, however, that a dividend is validly paid as a matter of company law, we are not aware of any authority which requires "dividend" to be given a different meaning for tax purposes. We do not believe that either *Memec plc v IRC* [1998] STC 754 or *Esso Petroleum Co. Limited v Ministry of Defence* [1989] STC 805 are authority for any such further test. Although it is stated that "the ordinary meaning of "dividend" is that it is a payment of a part of the profits for a period in respect of a share in a company", we believe that this is a short-hand reference to the company law requirement that dividends be paid out of profits available for the purpose. We do not believe that there is any intention to impose any further test that would mean that something which is a dividend as a matter of company law is not a dividend for tax purposes. Even if it were correct that a dividend paid out of reserves created on a capital reduction is not a dividend for tax purposes, it would be a distribution within section 209(2)(b) ICTA 1988. For the reasons given below, we do not believe it would represent a repayment of capital.

As regards the second argument, the effect of a reduction of capital is that part of the capital (this may be part of the issued share capital or share premium account) ceases to form part of the capital. When a company pays out by way of dividend part of the reserves created by the reduction, this is not a payment of capital. Furthermore, It is clear from cases such as *IRC v Reid's Trustees* [1949] AC 361 that whether a dividend is income or capital in the hands of shareholders does not depend on the source from which the dividend is paid by a company. In that case, it was held that a dividend paid out of a capital profit was nevertheless income arising from possessions out of the United Kingdom since the possessions, being the shares in the foreign company, remained intact. What determines the income or capital nature of a distribution by a company is the mechanism employed to make the distribution. So, in *Rae v Lazard Investment Co. Ltd* [1963] 1 WLR 555, Lord Reid stated:-

"In deciding whether a shareholder receives a distribution as capital or income our law goes by the form in which the distribution is made rather than by the substance of the transaction. Capital in the hands of the company becomes income in the hands of the shareholders if distributed as a dividend, while accumulated income in the hands of the company becomes capital in the hands of the shareholders if distributed in a liquidation."

Similarly, Lord Guest stated:-

"The character of a payment in the hands of a shareholder in this country is determined for all purposes by the legal machinery employed by the company acting under the relevant statutes."

Lord Pearce stated:-

"Thus it is not the source from which the assets are distributed but the machinery employed in their distribution which determines the question whether they are received as capital or income. They are received as capital if they are distributed as a bonus issue as in Blott's case or on an authorised reduction of capital or in a liquidation (see Inland Revenue Commissioners v Burrell. If, however, they are distributed in any other way they are received and taxable as income (Hill (R A) v Permanent Trustee Co. of New South Wales Ltd)."

For the reasons given above, we do not believe that existing case law justifies any change of approach in relation to dividends paid out of reserves arising on a reduction of capital. If policy compels a change, we believe that in view of the wide importance of the issue the change should be made as a result of legislation after appropriate consultation.

We would be very happy to meet to discuss the issues raised in this letter.

Yours sincerely

BRADLEY PHILLIPS
Chair
Revenue Law Committee

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The CLLS responds to issues of importance to its members through its 17 specialist committees. This letter has been prepared by the CLLS Revenue Law Committee.

THE CITY OF LONDON LAW SOCIETY
REVENUE LAW COMMITTEE

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