FOCUS

ORDINARY SHARE CAPITAL

Can a negative prove a positive?

The recent decision in *McQuillan v HMRC* highlights the challenges faced by taxpayers seeking to apply correctly those parts of the UK tax code that require interpretation in the absence of conclusive definition (*[2016] UKFTT 305 (TC)*).

McQuillan addresses whether shares with no dividend rights can be said to carry a fixed rate of dividend and therefore not be treated as ordinary share capital for the purposes of entrepreneurs' relief. In deciding that they did carry a fixed rate, the First-tier Tribunal (the tribunal) took a position that departs from both HM Revenue & Customs (HMRC) and market practice, and seemingly contradicts the recent tribunal decision in *Castledine v HMRC* (*[2016] UKFTT 145 (TC)*).

The dispute

Mr and Mrs McQuillan held shares in a trading company (the company). The issued share capital of the company comprised:

- 100 £1 ordinary voting shares (the ordinary shares).
- 30,000 £1 redeemable non-voting shares with no dividend rights (the redeemable shares).

The company's 30,100 issued shares were held as follows:

- Mr and Mrs McQuillan each held 33 ordinary shares.
- Two other shareholders each held 17 ordinary shares and 15,000 redeemable shares.

In December 2009, the redeemable shares were redeemed at par and on 1 January 2010 the company was sold, with the buyer acquiring the entire issued share capital of the company (that is, the remaining 100 ordinary shares).

Mr and Mrs McQuillan claimed entrepreneurs' relief in respect of the sale of their ordinary shares. HMRC denied the claims and Mr and Mrs McQuillan appealed to the tribunal. The availability of entrepreneurs' relief turned on whether the company was Mr and Mrs McQuillan's personal company (as defined in section 169S(3) of the Taxation of Chargeable Gains Act 1992) for the one-year period ending with the disposal, which itself turned on whether Mr and Mrs McQuillan held at least 5% of the ordinary share capital of the company (the 5% test) during this period.

The tribunal had to consider whether the 30,000 redeemable shares constituted ordinary share capital, which would count towards the 5% test. For these purposes, ordinary share capital is defined as all of the company's issued share capital, however described, other than capital where the holders of that capital have a right to a dividend at a fixed rate but have no other right to share in the company's profits (*section 989, Income Tax Act 2007*) (section 989).

The arguments

Mr and Mrs McQuillan argued that entrepreneurs' relief was available. There was a clear difference between the ordinary shares and the redeemable shares: the former had voting and dividend rights; the latter did not. The absence of a dividend right constitutes a dividend at a fixed rate, in the same way that a zero rate of VAT is a specific rate of VAT. Consequently, the redeemable shares did not satisfy the section 989 definition of ordinary share capital and so should not count towards the 5% test.

HMRC argued that entrepreneurs' relief was not available. As the redeemable shares carried no right to a dividend they were not shares with the "right to a dividend at a fixed rate" since it is not possible to have a fixed rate of 0%, apparently following the tribunal's decision in *Dyson v HMRC* that "nothing cannot be said to be a fixed rate" (*[2015] UKFTT 131*). Consequently, the redeemable shares satisfied the section 989 definition of ordinary share capital and so should count towards the 5% test.

Decision

The tribunal decided in favour of Mr and Mrs McQuillan. A right to no dividend is a right to a dividend at a fixed rate for the purposes of section 989. Consequently, the redeemable shares were not ordinary share capital, the 5% test was satisfied and the company was Mr and Mrs McQuillan's personal company.

The decision in context

The decision is surprising. By finding in favour of Mr and Mrs McQuillan, the tribunal may have opened Pandora's box.

HMRC practice. In support of its arguments, HMRC referred to its Employee Share Schemes User Guide (now its Employee Tax Advantaged Share Scheme User Manual) (the manual), which provides that ordinary share capital is defined in section 989 and that shares with no dividend rights may be accepted as ordinary share capital (and that HMRC does not contend that they carry the right to a fixed dividend of 0%) (*www.gov.uk/hmrc-internal-manuals/employee-tax-advantaged-share-scheme-user-manual/etassum43160*).

The tribunal noted that the manual implicitly acknowledges that there is an argument that shares with no dividend rights carry a right to a fixed dividend of 0%. As the tribunal ultimately decided not to follow HMRC's published practice, it seems that rather than strengthening HMRC's case the apparent equivocality implicit in the manual may have weakened it.

However, by departing from HMRC's published practice, questions will be raised as to the weight that the tribunal will attach to HMRC's published practice in court proceedings. The tribunal was clear that HMRC manuals are simply a non-binding expression of opinion. Although the approach of the tribunal was to the taxpayer's benefit on this occasion, this may not always be the case. Conversely, HMRC may be less willing to refer courts to its published practice in future cases for fear of risking adverse scrutiny.

The tribunal was also keen to point out that, at the time the redeemable shares were created, the potential future consequences for entrepreneurs' relief could not have been foreseen because entrepreneurs' relief did not exist at the relevant time. As a result, the tribunal said that it was sympathetic to Mr and Mrs McQuillan's situation. Perhaps that sympathy would not have existed if the redeemable shares had been deliberately designed not to carry a dividend right in order to ensure that they fell outside the definition of ordinary share capital.

Conflicting decisions. *McQuillan* appears to conflict with the tribunal's March 2016 decision in *Castledine* that certain deferred shares constituted ordinary share capital for the purposes of section 989 (*see box "The decision in Castledine"*). A possible explanation for this divergence is the manner in which the arguments were framed by the taxpayers. In *McQuillan*, the focus of the arguments was on the meaning of "dividend at a fixed rate" and whether the redeemable shares could be said to fall out of the scope of ordinary share capital.

In *Castledine,* Mr Castledine argued for a purposive interpretation of section 989 on the basis that Parliament would never have intended to categorise the deferred shares (having no economic value) as ordinary shares in the first place; in other words, it was not necessary to then look at whether the "dividend at a fixed rate" carve-out was applicable.

Also, the deferred shares in *Castledine* did not carry a meaningful right to the return of capital, unlike the redeemable shares in *McQuillan*, which did (although not a right to share in the company's profits). Indeed, the tribunal distinguished preference shares as having a right to share in profit along the lines of loan capital. This distinction is relevant when applying a purposive interpretation of section 989 in that, in terms of risk profile, shares that carry a fixed yield and a preferred right to a return of capital are more akin to debt investment than an entrepreneur's typical equity stake. Accordingly, the outcome in *Castledine* might have been different had the deferred shares carried a meaningful right to return of capital. Equally, had the tribunal adopted this line of reasoning in *McQuillan*, given that the redeemable shares did carry a meaningful right to return of capital, it might well have come to the same conclusion.

Having considered the relevant case law, the tribunal in *Castledine* noted that a purposive interpretation of legislation is only appropriate where a literal interpretation would defeat the obvious legislative intention and produce a wholly unreasonable result. On the facts before it, the tribunal concluded that applying the legislation in accordance with its plain meaning would not produce a wholly unreasonable result. Accordingly, the tribunal did not feel able to depart from its plain meaning.

Although the arguments were framed differently, and so allowed the tribunal to frame its decision differently, it is interesting that in *McQuillan* the tribunal considered the meaning of section 989 "not plain" and that, in such a case, considerations of common sense may be relevant; the "wholly unreasonable result" point was not addressed.

Implications

It is difficult to know where this leaves taxpayers: are shares with no voting and no dividend rights ordinary share capital? Would the answer differ if the shares carried a meaningful right to a return of capital?

Although both *McQuillan* and *Castledine* considered the definition of ordinary share capital in the context of entrepreneurs' relief, the concept is used more widely in the UK tax code. For example, it is used in:

- A number of the group relief rules, such as corporation tax, capital gains and stamp duty.
- The substantial shareholdings exemption.
- The corporate dividend exemption.
- Tax advantaged share schemes.
- Enterprise and seed enterprise investment schemes.

Given the inconsistency with *Castledine* and HMRC's view, HMRC may appeal *McQuillan*. Any appeal would hopefully alleviate the ambiguity that now exists in this area; uncertainty will remain until a higher court determines the point.

The decision in *Castledine*

Castledine v HMRC concerned Mr Castledine's claim for entrepreneurs' relief on the disposal of loan notes in Dome Holdings Limited (*[2016] UKFTT 145 (TC); www.practicallaw.com/3-627-1036*). Dome had in issue both ordinary and deferred shares; the latter having no voting or dividend rights. Ignoring the deferred shares, Mr Castledine held exactly 5% of Dome's ordinary share capital; including the deferred shares, he only held 4.99%. The issue, as in *McQuillan v HMRC*, was whether the deferred shares constituted ordinary share capital for the purposes of the 5% minimum ownership threshold in order to qualify for entrepreneurs' relief (*[2016] UKFTT 305 (TC)*).

The First-tier Tribunal (constituted differently from that in *McQuillan*) held that the deferred shares were ordinary share capital for the purposes of section 989 of the Income Tax Act 2007, despite the fact that they did not carry a right to dividends. As a result, Mr Castledine only held 4.99% of the ordinary share capital of Dome and, consequently, entrepreneurs' relief was not available in respect of the disposal of the loan notes.

So what should taxpayers do in the interim? In the first instance, companies that have issued shares with no dividend rights (whether or not the shares are deferred, redeemable or carry a meaningful right to a return of capital) should consider the impact that *McQuillan* and *Castledine* may have on the availability of any reliefs. This may be particularly important where planning was predicated on the shares forming part, or not forming part, of the ordinary share capital of the company. Until the uncertainty is resolved, it would be wise not to assume that deferred (or other) shares with no dividend rights fall outside the section 989 definition of ordinary share capital.

Pending resolution of this matter, it would seem prudent for companies wishing to issue shares that fall outside the definition of ordinary share capital to include a right to a fixed yield that is more than zero. Conversely, companies wishing to issue non-dividend bearing ordinary shares should be mindful of *McQuillan*, and might consider including some kind of right to share in the company's profit to ensure that these shares satisfy the section 989 definition of ordinary share capital.

However, this kind of structuring may not be straightforward, with the application of UK anti-avoidance rules (such as the disclosure of tax avoidance schemes and the general anti-abuse rule) requiring careful analysis, particularly in light of the approach taken by the court in relation to tax avoidance in *UBS AG v HMRC and DB Group Services (UK) Limited v HMRC* and *Advocate General for Scotland v Murray Group Holdings and others* (*[2016] UKSC 13, see News brief "Tax avoidance: Supreme Court adopts a purposive approach", www.practicallaw.com/6-625-0749; [2015] CSIH 77*).

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