

Ordinary share capital: clarity in relation to dividend rights

The Upper Tribunal has overturned the decision of the First-tier Tribunal in *McQuillan v HMRC*, finding that non-dividend bearing redeemable shares constituted ordinary share capital for the purposes of section 989 of the Income Tax Act 2007 (section 989) ([2017] UKUT 344 (TCC)) (see *Focus "Ordinary share capital: can a negative prove a positive?"*; www.practicallaw.com/2-631-2725).

While the decision is perhaps unsurprising given that the First-tier Tribunal's decision was a departure from HM Revenue & Customs' (HMRC) practice and conflicted with *Castledine v HMRC*, taxpayers should be mindful of its potential impact ([2016] UKFTT 145 (TC), www.practicallaw.com/3-627-1036).

Entrepreneurs' relief

Mr and Mrs McQuillan claimed entrepreneurs' relief in respect of the sale of their ordinary voting shares in a company. The availability of entrepreneurs' relief depended on whether the McQuillans held at least 5% of the ordinary share capital of the company during the one-year period ending with the disposal (the 5% test).

Ordinary share capital is defined in section 989 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. The issue for the First-tier Tribunal was whether the company's redeemable non-voting shares with no dividend rights (the redeemable shares) constituted ordinary share capital, which would count towards the 5% test.

Decision in taxpayers' favour

The First-tier Tribunal decided in favour of the McQuillans, finding that a right to no dividend is a right to a dividend at a fixed rate for the purposes of section 989 ([2016] UKFTT 305 (TC)). Consequently, the redeemable shares were not ordinary share capital, the 5% test was satisfied and so entrepreneurs' relief was available.

A reversal

The Upper Tribunal overturned the decision of the First-tier Tribunal, finding that the redeemable shares constituted ordinary share capital for the purposes of section 989. Accordingly, the Upper Tribunal held that

the 5% test was not satisfied with the result that entrepreneurs' relief was not available.

The Upper Tribunal firmly rejected the First-tier Tribunal's view that there was ambiguity in the literal meaning of section 989, holding that section 989 permits only one interpretation, and does not countenance a right to no dividend being a right to a dividend at a fixed rate.

The Upper Tribunal's view was that, before considering whether there was any argument that a zero rate could be a fixed rate for section 989 purposes, it must be determined whether there is a right to a dividend in the first place. As the First-tier Tribunal found as a matter of fact that the redeemable shares carried no right to a dividend, the Upper Tribunal considered this sufficient to conclude that the redeemable shares were not excluded from the definition of "ordinary share capital".

In other words, the First-tier Tribunal had ignored the prior requirement that there must be a right to a dividend and erroneously equated its finding that the redeemable shares had no right to any dividends with a conclusion that the shares had a right to a fixed dividend of 0%. The Upper Tribunal went on to note that even if such a construction of fixed rate were permissible, that could not give rise to a right to a dividend; it could only give rise to a right to no dividend or, put another way, no right to a dividend at all.

In any event, the Upper Tribunal held that it cannot be properly concluded that shares which have no right to a dividend should be regarded as having a right to a dividend at a fixed rate of 0% and so consequently have a right to a dividend, noting that this analysis is circular and flawed.

Purposive construction

The Upper Tribunal also went on to consider whether it was possible to construe section 989 purposively to enable the conditions for entrepreneurs' relief to be satisfied. The Upper Tribunal considered that the relevant purpose was the purpose of section 989 only, and not the entrepreneurs' relief regime, and, consequently, the Upper Tribunal was required to take into account the risk that its construction of section 989 could be unexpected and far-reaching. The

Upper Tribunal found that the purpose of section 989, like its drafting, was clear and unambiguous, and there was no process of purposive construction of section 989 that could enable the conditions for entrepreneurs' relief to be satisfied.

A dividing line

The Upper Tribunal also rejected arguments put forward by the McQuillans that section 989 should be analysed by reference to economic risk and reward, or the accounting treatment of the redeemable shares; that is, whether shares are classified as debt, rather than equity, for accounting purposes. A dividing line had been drawn in the legislation and, as a result, there would be hard cases that might lead to results that may be perceived as unfair but the Upper Tribunal held that it should fall to Parliament, not the court, to correct any traps for the unwary in order to address perceived unfairness.

Significance of the decision

It is difficult to argue against the logic underpinning the decision. It provides much needed clarity by re-establishing the strict dividing line to the meaning of ordinary share capital. Taxpayers crave certainty and, on that basis, the decision will largely be welcomed by those structuring their affairs around the need for issuing ordinary share capital and the consequences that brings. Although, of course, it may not be welcomed by those taxpayers whose planning was predicated on shares not forming part of a company's share capital.

That being said, while the decision may provide clarity on the meaning of ordinary share capital, it creates an element of uncertainty with respect to how courts will approach a purposive interpretation of legislation. For instance, in *McQuillan*, the Upper Tribunal took a somewhat restrictive, purposive approach in looking at the purpose of section 989 in isolation, without regard to the purpose of the entrepreneurs' relief regime, whereas in other recent decisions, the courts have taken a broader approach when considering the purpose of legislation. For example, in *UBS AG v HMRC*, the Supreme Court considered the relevant sections in the light of the purpose of the wider employment-related securities regime ([2016] UKSC 13) (see *News brief "Tax avoidance: Supreme*

Court adopts a purposive approach”, www.practicallaw.com/6-625-0749).

While this decision is clearly relevant for the purposes of entrepreneurs’ relief, as demonstrated by both *McQuillan* and *Castledine*, it is also relevant for other areas of the UK tax code which refer to ordinary share capital, including:

- A number of the group relief rules, such as corporation tax, capital gains tax and stamp duty.

- The substantial shareholdings exemption.
- The corporate dividend exemption.
- Tax-advantaged share schemes.
- Enterprise and seed enterprise investment schemes.

Practical impact

Following *McQuillan*, where a company wishes to issue shares that fall outside of ordinary share capital, it should consider

expressly including a right to a fixed yield that is any number greater than zero. However, this is not as straightforward as it may first appear; the application of UK anti-avoidance rules requires careful analysis, particularly in light of the recent approach taken by the courts in relation to tax avoidance.

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