Wrong sort of dividend

Large Corporate

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Bill Dodwell examines the recent Next Brand Ltd ‘rate-booster’ case

Judge Colin Bishopp has just given his decision in a case about ‘rate boosters’. The case dates back to the time when the UK levied corporation tax on foreign dividends. Even a decade ago, the UK’s corporation tax rate at 30% was lower than the main rates in many of our main trading partners. The evidence when the dividend exemption was introduced in 2009 was that little UK tax was actually collected on foreign dividends. The costing in the 2008 pre-Budget report showed that the new dividend exemption would cost about £275 million annually. Most of that cost came from portfolio dividends, ie dividends where the shareholding was less than 10%. The cost of abolishing corporation tax on dividends from subsidiaries was thought to be less than £100 million annually.

Part of the reason that the abolition cost was so low was that UK multinationals with low-taxed foreign income simply didn’t repatriate that money. Instead, low-taxed profits were typically re-invested overseas. However, this didn’t work for some groups with substantial amounts of low-taxed profits. As a result, some advisers looked to find a way to ‘gear up’ the value of tax credits. A version of these ideas came to the tribunal in *Next Brand Ltd v HMRC* [2015] UKFTT 175 (TC).

The basic idea was to find a way to pay a dividend with a tax credit – but do so in such a way that the recipient needed to write down the investment value of the shares. This meant that the income was broadly offset by the write-down – so that a small amount of income was left with a huge tax credit attached. This could then be averaged with a large amount of income from overseas – with a small tax credit attached.

The route chosen here was to create a special class of irredeemable preference shares in a UK company – with unusual rights. The shares had a nominal value of 1p and were issued at a premium of 99p. There was a right to a single, non-cumulative dividend of 99p and a cumulative annual dividend of 6% on the nominal value. The UK company concerned had substantial distributable reserves and it had paid large amounts of UK corporation tax. Its UK parent subscribed £75 million for irredeemable preference shares and, some time later, sold the shares at market value to the overseas trading company. The overseas company in this case was based in Hong Kong, where it earned substantial profits but paid tax at the low Hong Kong rate. Soon afterwards, the Hong Kong company called for the special dividend of 99p per share and the UK company also paid the 6% dividend as well. The Hong Kong company accounted for most of the dividend received by writing down the investment value of the shares – in other words, little profit arrived in the profit and loss account.

The old rules on underlying tax provided that the Hong Kong company should add to the tax it had borne on its own profits' tax born by subsidiaries on their profits, to the extent that those profits had been distributed upwards.

The case was complicated by the financing arrangements – in that money was lent within the group to cover the initial share subscription, the sale of the preference shares to the overseas company and then the payment of the various dividends. It shouldn't be very surprising that individual companies wouldn't naturally have a spare £75 million lying around – but the modern way of accounting for some preference shares as financing certainly gave the appearance that some of the payments could be viewed as financing payments rather than simply as dividends.

Unsurprisingly HMRC disputed the claim that the underlying tax in the Hong Kong company had been boosted by additional UK tax when dividends were paid to the Hong Kong company. The judgment notes 'HMRC argue that there is an additional requirement, namely that the relevant profits of the overseas company have been increased by the amount of the dividend received'. In this case, the whole efficacy of the arrangements depended on not increasing the profits by the full amount of the dividend received. Ultimately judge Bishopp concluded that the references in the double tax relief sections to income and dividends meant '…dividends representing the payment of profit, and not dividends with some other purpose...' In this case, the special dividend of 99p per share was treated as derived from the original subscription – and not from the overall pool of taxed, distributable, profits in the UK company. The underlying UK tax could not be taken into account.

This is the second case concerning a rate-booster scheme. The First-tier Tribunal also ruled against P&O, in a case involving deemed underlying tax – as opposed to actual tax here. The *P&O* case is now before the Upper Tribunal. HMRC have said that about £130 million in tax is at stake across 20 rate-booster cases – but that about 70 similar cases have already been conceded, bringing in more than £500 million in tax. While we can all understand the desire of HMRC to limit this type of historical planning, some of the tribunal's conclusions about dividends do not sit comfortably when applied in a more general context. Perhaps we should hope that this case, too, heads upwards?