Much ado about nothing

Management of taxes OMB

01 August 2016

Keith Gordon discusses a First-tier decision concerning entrepreneurs' relief and the statutory definition of ordinary share capital

Key Points

What is the issue?

In the case of McQuillan v HMRC, the FTT allowed the McQuillans' appeal on the ground that shares that do not carry any right to dividends carry a right to a ‘dividend at a fixed rate’ (of zero).

What does it mean to me?

The terms of the FTT’s decision in McQuillan suggest that the tribunal considered that the definition of ordinary share capital might differ in different cases.

What can I take away?

Tax advisers should be constantly alert to the risk that their entrepreneurial clients might somehow be denied entrepreneurs’ relief simply because of a quirk in the rules.

Advisers will know that for entrepreneurs’ relief to apply on the disposal of company shares, other than EMI shares, the rules require (inter alia) the relevant shareholders to hold at least 5% of the company’s ordinary share capital (and voting rights) throughout the final year before the disposal (or, if applicable, before the company ceases to be a trading company or a member of a trading group) (Taxation of Chargeable Gains Act 1992, sections 169I(6), (7) and 169S(3)).

This 5% rule is rigidly adhered to as the recent case of *Castledine v HMRC* [2016] UKFTT 0145 (TC) will testify. In that case, Mr Castledine was denied entrepreneurs’ relief because of the existence of some practically worthless deferred shares held by some former employees which took Mr Castledine’s percentage shareholding down from precisely 5% to 4.995%.

The key to the difficulty faced by Mr Castledine is the definition of ordinary share capital which, through s 169S(5), is found in the Income Tax Act 2007, s 989 and which reads as follows:

> ‘ordinary share capital’, in relation to a company, means all the company’s issued share capital (however described), other than capital the holders of which have a right to a dividend at a fixed rate but have no other right to share in the company’s profits.

Given the deferred shares fell within this definition, the tribunal had to conclude that Mr Castledine’s shareholding was too small to qualify for relief.

The definition has arisen again in yet another entrepreneurs' relief case – *McQuillan v HMRC* [2016] UKFTT 305 (TC).

Facts of the case

There were two appellants, a husband and wife, Mr and Mrs McQuillan. They incorporated a trading company in 2004, each taking 33 ordinary shares. The company's remaining 34 shares were held 17 each by another married couple, Mr and Mrs Pennick. (Mrs Pennick is Mr McQuillan's sister.) Mr and Mrs Pennick were invited to subscribe for their shares because they had skills that Mr and Mrs McQuillan believed would be of use to grow the company's business. Furthermore, at some point in time, Mr and Mrs Pennick advanced £30,000 to the company which was accounted for as a directors' loan.

As the company continued to prosper, in 2006 it sought a grant from Invest Northern Ireland. A grant was duly offered but only on condition that the directors' loan be converted to shares (to give Invest Northern Ireland the confidence that the proceeds from the grant would not simply be used to repay the loan to Mr and Mrs Pennick). A further condition was that the loan would not be repaid before March 2009.

In consequence, the company converted the loan to redeemable ordinary shares of £1, leaving the original shareholders with their 33 (for each of Mr and Mrs McQuillan) and 17 (for each of Mr and Mrs Pennick) voting shares and Mr and Mrs Pennick with 30,000 non-voting shares between them. The documentation made it clear that the non-voting shares were redeemable at par at the directors' sole discretion but was silent as to any dividend rights attaching to them.

In late 2009, the shareholders received an offer to sell their shares in the company. As a result, the redeemable shares were immediately redeemed at par. A few days later, the company resolved to pay a dividend of £700 per share – being the only dividend ever paid by the company prior to the subsequent sale. The sale was completed on 1 January 2010 and Mr and Mrs McQuillan ceased any ongoing connection with the company.

They claimed entrepreneurs' relief in respect of the gains arising on the disposal of their shares. Their claims were challenged by HMRC on the basis that the 5% rule was not satisfied during most of the 12 months immediately before the disposal. Mr and Mrs McQuillan appealed against HMRC's decision to the First-tier.

The tribunal's decision

The case came before Judge Christopher Staker.

The tribunal made a finding of fact that the shareholders did not consider the redeemable shares to confer any rights other than that of repayment of the £30,000 loan. This understanding was confirmed by the parties' actions when the purchase offer was received.

The tribunal then stated that the case boiled down to a single point – whether the redeemable shares fell within the meaning of 'ordinary share capital'. That the shares were described as ordinary (albeit redeemable) is beside the point. The definition catches all shares except those that confer a right to a dividend at a fixed rate and have no other right to share in the company's profits. Furthermore, since the redeemable shares gave the shareholders no stake in the company's profits (besides the repayment of the original loan capital), the question was whether the lack of any right to a dividend was equivalent to a right to a dividend at a fixed rate of zero.

Having recognised that the shares would have been excluded from the meaning of ordinary share capital had they carried a minuscule right to a dividend (the tribunal suggested 1/15,000 of a penny), the tribunal concluded that the Pennicks' redeemable shares, which carried no dividend rights, should similarly fall outside the definition. As a result, they could be ignored when determining Mr and Mrs McQuillan's entitlement to entrepreneurs' relief. Therefore, the latter's shareholdings each represented 33% of the company's ordinary share capital.

Consequently, the appeals were allowed.

Commentary

The result is clearly very sensible in the circumstances and one would hope that HMRC will decide not to appeal against it.

However, one should note a number of issues that led to the tribunal’s conclusion and could lead to a different result in other cases.

First, the terms of the decision suggest that the tribunal considered the definition of ordinary share capital might differ depending on the case. If that is what the Tribunal meant, then that must be wrong. The tax code contains a single definition of the term (in s 989) to be used in many circumstances. It cannot exclude the redeemable shares held by Mr and Mrs Pennick in one situation but include them in another. Of course, it might be appropriate for different definitions to apply in different cases, but that is something that only Parliament can effect. Equally, it should be stressed that that particular comment does not in itself invalidate the rest of the decision given that the tribunal felt that it was not departing from any binding precedent and the comment was more a throwaway remark. On that point, it is of course worth noting that the tribunal’s own decision is not binding.

It is also worth noting that, as part of its submissions, HMRC referred to its guidance in its own manuals which the tribunal (correctly) noted was not of legal authority. Nevertheless, the tribunal remarked on the fact that ESSUM43230 stated that HMRC ‘may accept as ordinary share capital shares with no dividend rights’ and that HMRC ‘do not contend that they carry the right to a fixed dividend of 0%’. The phrasing used in the manuals could suggest that HMRC generally accepts that such shares are not properly ordinary shares in that they do in fact carry the right to a fixed dividend of 0% and that it just happens to be the case that HMRC does not usually press the point. Of course, it could be simply that the manuals are clumsily worded.

The second point is more specific to the facts of the case. The tribunal noted that the documented agreement reached by the shareholders when the redeemable shares were created ‘was silent’ in respect of any dividend rights attaching to the various classes of share.

Arguably, therefore, the written documents when considered alone do not even justify the conclusion that the redeemable shares qualified for a fixed dividend of 0%. Nevertheless, the tribunal (correctly in my view) took a more holistic approach and determined the reality of the agreement of the parties, which goes wider than those terms as formally recorded.

Given the history of the loan, the circumstances in which it was converted to share capital and the corroborative evidence of what happened when the loan was subsequently redeemed, the tribunal was entitled to conclude that the shares did indeed carry no entitlement to dividend.

Readers should of course be aware that such a conclusion might not be so readily available in another case and, so, it is always advisable to ensure that written records of shareholder agreements are as comprehensive as possible.

In *McQuillan*, the conversion of the loan to redeemable shares took place long before entrepreneurs’ relief was ever conceived and therefore the parties cannot be criticised for creating a potential elephant trap. There again, although the use of harmonised definitions should often be commended, there is also much to be said for thought being applied before existing definitions are recycled without proper consideration of the potential consequences. Entrepreneurs’ relief was enacted in rather a hurry (which is a symptom of a further problem in the tax system) and there is every possibility that the policy was devised by individuals who had no real experience of how companies are capitalised in the real world. Perhaps the OTS could add the question of the suitability of a standard definition of ordinary share capital to each case where the definition is currently applied to its ever increasing list of matters where the tax system is spiralling out of control.

Of course, tax advisers should not simply leave everything to government and Parliament. They should also be constantly alert to the risk that their entrepreneurial clients might somehow be denied entrepreneurs’ relief simply because of a quirk in the rules. And, given that the conditions must be satisfied throughout the year before the relevant disposal, it will usually be too late if matters are not reviewed until a sale is in the offing.

Even if the *McQuillan* case goes no further – or should an HMRC appeal prove unsuccessful – the cost and worry of the entire process suffered by Mr and Mrs McQuillan might well have been avoided had the matter been considered proactively. To misquote Shakespeare, ‘Cupid kills with arrows, Parliamentary Counsel with traps’.