Capital or revenue: tax treatment of distributions

Personal tax

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The case of *Beard v HMRC* considers the tax treatment of distributions received from non-UK companies following *First Nationwide*.

Key Points

What is the issue?

Mr Beard, a UK tax resident, received substantial cash and *in specie* distributions from the share premium of a Jersey incorporated and non-UK resident company, Glencore PLC. When HMRC assessed Mr Beard to income tax on the distributions, he appealed.

What does it mean for me?

The Upper Tribunal held that the reasoning in the case of *First Nationwide* should be applied to the tax treatment of distributions received from non-UK companies in the (different) context of the Income Tax (Trading and Other Income) Act 2005.

What can I take away?

UK tax practitioners considering whether a dividend should be regarded as capital or revenue may benefit from having regard not only to the local law distribution machinery, but also to the wider commercial substance of any transaction giving rise to the dividend.

The Upper Tribunal decision in *Alexander Beard v HMRC* [2024] UKUT 73 (TCC) may interest tax practitioners who find themselves grappling with the UK tax treatment of distributions received from non-UK companies, particularly for income tax purposes.

The decision could also merit wider attention in relation to comments made by the Upper Tribunal about the role that can and should be played by case law predating the Tax Law Rewrite Project when interpreting ‘basic’ concepts (such as the concept of ‘capital’) found in Tax Law Rewrite Project legislation.

Those who can remember the *First Nationwide* litigation rumbling on (particularly the decisions of the Upper Tribunal [2011] UKUT 174 (TCC) and Court of Appeal [2012] EWCA 278) may remember the sense of uncertainty that resulted from arguments made in that case regarding the tax treatment of non-UK company distributions. Anyone alarmed at the news that some of those arguments have recently been revisited by the Upper Tribunal in *Beard* might, however, be comforted to hear the tribunal’s conclusions.

Agreeing with the First-tier Tribunal (and HMRC), the Upper Tribunal held that the reasoning of the Upper Tribunal and Court of Appeal in *First Nationwide* should be applied to the tax treatment of distributions received from non-UK companies in the (different) context of Income Tax (Trading and Other Income) Act (ITTOIA) 2005. The Upper Tribunal decision provides clarity on how this should take place. It also underscores the importance of understanding the local law mechanics of non-UK company distributions made from share premium when analysing such distributions for UK tax purposes.

The Upper Tribunal's reasoning would also suggest that regard should be had to the substance of the overall transaction of which any dividend forms part, since in rare cases that may impact whether the dividend should be regarded as having a 'capital nature'.

Background

Mr Beard, a UK tax resident, received substantial cash and *in specie* distributions (the 'distributions') from the share premium of a Jersey incorporated and non-UK resident company, Glencore PLC. HMRC assessed Mr Beard to income tax on the distributions. Mr Beard appealed to the First-tier Tribunal.

Mr Beard maintained that he should not be charged to income tax further to ITTOIA 2005 s 402. This provides, amongst other things, that income tax is charged on 'dividends' (not defined in ITTOIA 2005) received from a non-UK resident except for 'dividends of a capital nature' (also not defined). It was argued for the taxpayer (represented by Malcom Gammie KC, who acted for HMRC in *First Nationwide*) that in effect the distributions were not dividends and in any event were of a capital nature, such that the distributions should instead be charged to capital gains tax.

The First-tier Tribunal rejected Mr Beard's appeal. Mr Beard appealed to the Upper Tribunal.

Decision of the Upper Tribunal

The Upper Tribunal decision covers three questions of interest.

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1. When are distributions 'dividends'?

To decide whether a distribution from a non-UK company is a 'dividend', the parties agreed that one should:

- consider the ordinary meaning of the term 'dividend' in English law; and
- look at the non-UK law governing the distribution.

The first issue for the Upper Tribunal to consider was how to approach this analysis for the distributions.

By way of context, in *First Nationwide*, distributions had been declared out of the share premium account of a Cayman Islands company. The question arose as to whether such distributions were ‘dividends’ for the purposes of a different tax provision pre-dating the Tax Law Rewrite Project.

Cayman Islands company law allowed distributions from share premium in a similar manner to distributions from retained earnings, provided that the company making the distribution remained able to pay its debts. Looking at the position under Cayman Islands law, the Upper Tribunal decided that the distributions were ‘dividends’.

However, the position of share premium in Jersey company law is arguably less clear in certain respects than in Cayman Islands company law. Share premium in Jersey occupies, as the First-tier Tribunal had put it, a ‘hybrid territory’ between Cayman Islands and English company law. Jersey law contains, on the one hand, provisions that would seem to protect the share premium account as share capital of the company and, on the other hand, provisions that freely permit distributions out of share premium in a similar manner to distributions out of retained earnings. How then should the distributions made in this case from Jersey share premium be analysed?

The Upper Tribunal agreed with the First-tier Tribunal (and HMRC) that the distributions should be regarded as dividends, for reasons that we would summarise as follows.

First, the hybrid nature of the share premium account in Jersey law did not dissuade the Upper Tribunal from characterising the distributions as dividends. The local law mechanism by which the distributions were made proved key. Since the distributions were made from share premium using the same mechanism as that used for making dividends out of trading profits, the distributions could properly be regarded as dividends.

Second, the Upper Tribunal struggled to see any conceptual bar to regarding distributions out of share premium as ‘dividends’ under the ordinary meaning of that term.

Counsel for Mr Beard had referred to the Court of Appeal decision in *Memec plc v IRC* (1998) 71 TC 77 (following *Esso Petroleum Co Ltd v MoD* [1990] Ch 163) in which a dividend is described as 'a payment out of part of the profits for a period in respect of a share in a company'. It was argued that the distributions did not meet this description since, when one considers the position of the share premium account in Jersey company law, the share premium from which the distributions were made should be regarded as capital rather than profit.

The Upper Tribunal was unconvinced. It noted that dividends out of share premium had once been possible in English company law. The Upper Tribunal concluded (in para 42) that the *Memec* description of a 'dividend' relied on by counsel for Mr Beard was (in its view) rightly characterised by the Upper Tribunal in *First Nationwide* (in para 37 of that decision) as a description that should not be treated as 'legislation' when applied out of context.

The Upper Tribunal also notes judicial commentary to the effect that share premium can in any event be said to represent profit for a period (*Re Duff's Settlement Trusts* [1951] Ch 721 and the Upper Tribunal in *First Nationwide*).

As such, the Upper Tribunal describes as 'impeccable' the First-tier Tribunal's conclusion amongst other points that:

> '[T]he distributions fulfil almost exactly the example description provided in *First Nationwide*…
> [T]here is nothing either in the Jersey legislation or in the manner in which these payments were made by Glencore to indicate that the distributions cannot be treated as fulling [sic] the English law definition of a dividend.'

Many may find this conclusion reassuring.

A final observation: it appears that UK tax practitioners do not have a hard and fast definition of 'dividend' to work with when considering non-UK company distributions. Although this seems unlikely to present a problem for most cases, careful thought may be necessary when considering more unusual distributions from non-UK companies.

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2. When are dividends 'of a capital nature'?

The next question for the Upper Tribunal was whether the distributions were in any event dividends of a ‘capital nature’ (per s 402(4)). How should this be analysed given the unusual status of the share premium account in Jersey law, as well as the different tax law context compared to that considered in *First Nationwide*?

The Upper Tribunal held that the distributions were not dividends of a capital nature, for the following two reasons.

The ‘method of distribution’ test

Distributions have a capital nature if they involve a diminution of the ‘corpus of the assets’ of the company (per the House of Lords in *Rae v Lazard Investment Co Ltd* (1963) 41 TC 1). The Upper Tribunal considered that, further to *Rae v Lazard* and the analysis of the Court of Appeal in *First Nationwide*, the mechanism of distribution determines whether the corpus of the assets is reduced by the distribution.

The Upper Tribunal considered that approach appropriate for s 402(4), given that the statutory expression ‘dividends of a capital nature’ would seem to focus on the character of the dividend itself not, as counsel for Mr Beard had argued, the character of the source of funds.

In reaching this conclusion, the Upper Tribunal did not accept the argument made for Mr Beard that s 402 had the effect of creating a third category of receipt between income and capital; namely, ‘a receipt which is paid as a dividend from what is treated under the law of the company as the capital of the company’. The Upper Tribunal relied on comments in the Explanatory Note for ITTOIA 2005, which sought to place s 402 into the context of the established case law where only two categories of payment in respect of shares are recognised: capital and revenue.

The Upper Tribunal also commented on the proper role that should be played by case law predating the Tax Law Rewrite Project (see below).

Applying this ‘method of distribution’ test, the Upper Tribunal concluded that the distributions should not be seen as having a capital nature since the mechanism by which the distributions were made by Glencore PLC was the same mechanism as that used for making dividends out of trading profits. The distributions had not been made by the alternative mechanism provided for in Jersey law for reducing capital.

(In any event, although the Upper Tribunal did not appear to see the character of the source of funds as determinative, it endorsed the First-tier Tribunal's rejection of the idea that share premium has an essential character as capital, agreeing with it that share premium instead has a 'chameleon character, taking its colour from the law which is applied to it'.)

However, does such a focus on distribution mechanics tend to put form over substance? The Upper Tribunal thought not, appearing to regard the decision of the company to use one distribution mechanism rather than another as a reasonable dividing line, drawing support for that approach from comments by the House of Lords in the trust case *Bouch v Sproule* (1887) 12 App Cas 385.

The 'dividend which could not on any sensible view be regarded as income' test

It was argued for Mr Beard that the above approach has the effect of rendering redundant the s 402(4) concept of 'dividends of a capital nature'. The Upper Tribunal decision does not relay the details of this argument. However, perhaps we might put the question this way: if both issues of 'dividend' and 'capital nature' are determined by reference to the distribution machinery, in what circumstances would one ever conclude that a distribution can be both a 'dividend' and 'of a capital nature'?

The Upper Tribunal's answer to this is that s 402(4) is directed at dividends which 'cannot on any sensible view be regarded as income' (para 75).

The Upper Tribunal gives *Sinclair v Lee* [1993] Ch 497 as an example of a case in which the wider facts and circumstances meant that a dividend *in specie* from an English company arising on a demerger could not sensibly be regarded as 'income' for trust law purposes. The court in *Sinclair v Lee* had considered that to conclude otherwise would 'exalt company form over commercial substance to an unacceptable extent'.

The Upper Tribunal also notes (para 75) that it is 'impossible to envisage all the circumstances in which a company may pay a dividend, in particular when s 402 is concerned with companies incorporated under a multitude of foreign laws which may include procedures and arrangements unknown in the UK.'

The Upper Tribunal found no such problem with the distributions, concluding that s 402(4) should not apply.

Evidently, the Upper Tribunal sees as the target of s 402(4) those unknown unknowns where the substance of the overall transaction of which the dividend forms part forces one to conclude that the dividend in question ‘cannot on any sensible view be regarded as income’. Therefore, although s 402(4) might reasonably be expected to apply only rarely, in view of the Upper Tribunal’s decision in *Beard*, UK tax practitioners considering whether a dividend should be regarded as capital or revenue may benefit from having regard not only to the local law distribution machinery, but also to the wider commercial substance of any transaction giving rise to the dividend.

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3. Applying previous case law to Tax Law Rewrite Project legislation

The Upper Tribunal also made comments about the proper role played by tax case law pre-dating the Tax Law Rewrite Project when analysing Tax Law Rewrite Project legislation.

First Nationwide concerned tax law pre-dating the Tax Law Rewrite Project, whereas s 402 was a product of the Tax Law Rewrite Project. Counsel for Mr Beard argued that the earlier authorities, in particular *First Nationwide*, were inappropriately relied upon by the First-tier Tribunal in *Beard*.

The Upper Tribunal disagreed. It acknowledged the, as yet unanswered, question noted by the Supreme Court in *NCL Investments Ltd v HMRC* [2022] UKSC 9 of ‘whether and when it is appropriate to refer to earlier case law either in relation to a consolidation statute properly so called or to a Tax Law Rewrite Project statute’. The Upper Tribunal also accepted that ‘in order to interpret a new statutory provision it may well be inappropriate to rely on a previous case which determined the meaning of another, and now replaced, statutory provision’.

However, the Upper Tribunal concluded that there was nothing in the relevant authorities which meant that the tribunal should ‘eschew the assistance’ provided by cases dealing with such ‘basic’ and widely used concepts as income and capital (para 52). Although arguably unsurprising, this comment by the Upper Tribunal may merit attention when analysing other similarly fundamental and pervasive tax law concepts.