[2016] UKFTT 0305 (TC)

TC05074

Appeal number: TC/2014/05054
TC/2014/05055

CAPITAL GAINS TAX – Entrepreneurs' relief – Definition of "personal company (s 169S(3) TCGA) – Definition of "ordinary share capital" (s 989 ITA 2007) – Whether shares with no right to a dividend have "a right to a dividend at a fixed rate"

FIRST-TIER TRIBUNAL
TAX CHAMBER

MICHAEL MCQUILLAN **Appellants**
ELIZABETH MCQUILLAN

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS **Respondents**

TRIBUNAL: JUDGE CHRISTOPHER STAKER

Sitting in public at Belfast on 22 January 2016

Mr Joseph Murray, accountant, for the Appellants

Mr John Corbitt, presenting officer, for the Respondents

DECISION

Introduction

1. The Appellants appeal against closure notices dated 17 April 2014 issued by HMRC in respect of tax year 2009-10. The effect of the closure notices was to disallow the claims for entrepreneur's relief that had been made by the Appellants in their self-assessment tax returns in respect of the sale of certain shares in January 2010.

The facts

2. This appeal turns on a point of law, and the facts are largely undisputed. On the basis of the evidence before it, including oral evidence given by the Appellants at the hearing that was not contested by HMRC, the Tribunal makes the following findings of fact.

3. The Appellants are husband and wife. In 2004, they decided to franchise a business that they had established in 1999. For this purpose, they established a company which was incorporated on 24 August 2004 (the "**Company**"). When the Company was incorporated the issued share capital consisted of 100 £1 ordinary shares. The Appellants each held 33 of these shares, and another couple, Mr and Mrs Pennick, held 17 each. Mrs Pennick is the first Appellant's sister. Mr and Mrs Pennick were brought in because they had skills that were valuable to the growing of the business. Mr and Mrs Pennick at some point lent £30,000 to the Company, which was shown in the company accounts as a directors' loan.

4. The Company's business was successful, and it continued to grow. In early 2006, the Company approached Invest Northern Ireland ("**Invest NI**") for certain grants. Invest NI offered grants to the Company, but on the precondition that Mr and Mrs Pennick's directors' loan be converted to shares. This was to give Invest NI the confidence that new funding from Invest NI would not be used as replacement funding simply to repay the loan from Mr and Mrs Pennick. It was a condition imposed by Invest NI that the loan from Mr and Mrs Pennick not be repaid before March 2009.

5. Accordingly, at a directors' meeting on 12 June 2006, it was resolved that the £30,000 advanced to the Company by Mr and Mrs Pennick be converted to redeemable ordinary shares of £1 each. An amendment was made to the shareholder agreement, which as amended now provided as follows. The Company had an authorised share capital of £100,000, divided into 100,000 shares of £1 each, of which 100 voting shares and 30,000 non-voting shares had been issued at par. The Appellants each held 33 voting shares. Mr and Mrs Pennick each held 17 voting shares and 15,000 non-voting shares. The shareholder agreement provided that "Any Redeemable Share Capital from time to time in issue shall not bear any voting rights and will be redeemable at par at a future date decided by the Directors at their sole discretion". The shareholder agreement provided that any dividends would be paid to the shareholders, but was silent on the question of the proportion in which they would be paid.

6. In the autumn of 2009, a larger enterprise offered to buy the Company. In the process leading up to that sale, at a directors' meeting on 14 December 2009, the directors resolved that the 30,000 non-voting redeemable shares be redeemed at par with immediate effect. At a further directors' meeting on 23 December 2009, it was resolved to pay a dividend for the period ended 31 October 2009 of £700 per share. This was the only dividend that the Company ever paid prior to the sale. On 1 January 2010, the purchasers of the Company acquired all of the 100 issued shares, and the Appellants and Mr and Mrs Pennick ceased to have anything to do with the Company.

7. On the evidence presented at the hearing, the Tribunal is satisfied of the following. The Appellants and Mr and Mrs Pennick always agreed and understood between themselves that the 30,000 redeemable shares would have no right to any dividends, and conferred no rights of ownership over the business, and that these shares represented merely an interest free loan of £30,000 by Mr and Mrs Pennick to the Company. The possibility was never entertained by either Mr and Mrs Pennick or the Appellants that the redeemable shares would in any way feature in the sale of the Company, and it was in accordance with their common understanding that the 30,000 redeemable shares were redeemed at face value prior to the sale of the Company.

8. In their 2009-10 self-assessment tax returns, the Appellants claimed entrepreneurs' relief in respect of the capital gains tax payable on the sale of their shares in the Company.

9. HMRC subsequently opened an enquiry into those self-assessment tax returns. After various correspondence with the Appellants' representatives, on 15 April 2014 HMRC issued closure notices which concluded that the Appellants were not entitled to entrepreneurs' relief on the sale of the their shares in the Company, and that they had therefore paid too little tax.

10. Further correspondence between the Appellants and/or their representatives and HMRC ensued. On 1 May 2014, the Appellants advised HMRC that the final amount earned from the sale of the shares was less than originally returned, due to the "earn-out" nature of the share sale.

11. On 13 August 2014, HMRC issued a statutory review decision upholding the decision that the Appellants were not entitled to claim entrepreneurs' relief, but amending the amount of underpaid tax to take account of the Appellants' notification of the amendment to the amount of the sale proceeds. The review decision concluded that each of the Appellants had not, throughout the period of 1 year ending with the date of the share sale, held at least 5% of the ordinary share capital of the Company. This was because during part of that 1 year period, the ordinary share capital had included the 30,000 redeemable shares, such that each of the Appellants had held only 33 of 30,033 £1 shares, which is to say 0.001% of the ordinary share capital.

12. By a notice of appeal dated 11 September 2014, the Appellants brought the present Tribunal appeal.

Applicable legislation

13. Section 169H of the Taxation of Chargeable Gains Act 1992 ("**TCGA**") relevantly provided at the material time as follows:

> **169H Introduction**
>
> (1) This Chapter provides relief from capital gains tax in respect of qualifying business disposals (to be known as "entrepreneurs' relief").
>
> (2) The following are qualifying business disposals–
>
> (a) a material disposal of business assets: see section 169I …

14. Section 169I TCGA relevantly provided at the material time as follows:

> **169I Material disposal of business assets**
>
> (1) There is a material disposal of business assets where–
>
> (a) an individual makes a disposal of business assets (see subsection (2)), and
>
> (b) the disposal of business assets is a material disposal (see subsections (3) to (7)).
>
> (2) For the purposes of this Chapter a disposal of business assets is–
>
> …
>
> (c) a disposal of one or more assets consisting of (or of interests in) shares in or securities of a company.
>
> …
>
> (5) A disposal within paragraph (c) of subsection (2) is a material disposal if condition A or B is met.
>
> (6) Condition A is that, throughout the period of 1 year ending with the date of the disposal–
>
> (a) the company is the individual's personal company and is either a trading company or the holding company of a trading group, and
>
> (b) the individual is an officer or employee of the company or (if the company is a member of a trading group) of one or more companies which are members of the trading group.
>
> …

15. Section 169S(3) TCGA provided at the material time as follows:

> (3) For the purposes of this Chapter *"personal company"*, in relation to an individual, means a company–
>
> (a) at least 5% of the ordinary share capital of which is held by the individual, and
>
> (b) at least 5% of the voting rights in which are exercisable by the individual by virtue of that holding.

16. Section 989 of the Income Tax Act 2007 ("**ITA 2007**") relevantly provided at the material time as follows:

> The following definitions apply for the purposes of the Income Tax Acts–
>
> *"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,

17. Section 1(3) ITA 2007 provided at the material time as follows:

> (3) Schedule 1 to the Interpretation Act 1978 (c. 30) defines *"the Income Tax Acts"* (as all enactments relating to income tax).

18. Section 5 the Interpretation Act 1978 provided at the material time as follows:

> In any Act, unless the contrary intention appears, words and expressions listed in Schedule 1 to this Act are to be construed according to that Schedule.

19. Schedule 1 to the Interpretation Act 1978 relevantly provided at the material time as follows:

> *"The Income Tax Acts"* means all enactments relating to income tax, including any provisions of the Corporation Tax Acts which relate to income tax.

The Appellants' arguments

20. The Appellants argue as follows. They have provided evidence that they each owned 33% of the business. It is necessary to consider all of the transactions and events from the inception of the business to its acquisition. There was a clear difference between the redeemable shares and the shares held by the Appellants. The former had a fixed dividend of 0% and no voting rights. The latter yielded a 33% dividend and voting rights. A fixed dividend of 0% is a "a dividend at a fixed rate", just like a zero rate of VAT is a specific rate of VAT. To deny entrepreneurs' relief would be inconsistent with the spirit and intention of the legislation. Entrepreneurs' relief was introduced into the legislation only in 2007. At the time that Invest NI required the £30,000 loan to be converted into redeemable shares in 2006, neither Invest NI nor the Appellants could have realised that this might have implications for entrepreneurs' relief when it was subsequently introduced.

The HMRC arguments

21. The legislation relevant to this appeal is unambiguous. By virtue of s 169I(6) TCGA, the Company must have been, throughout the period of 1 year ending on 1 January 2010, the Appellants' personal company. By virtue of s 169S(3), this means that throughout this period, each of the Appellants was required to have held at least 5% of the ordinary share capital and at least 5% of the voting rights exercisable by virtue of that holding. By virtue of s 989 ITA 2007 the expression "ordinary share

capital" includes all share capital 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. The 30,000 redeemable shares issued in June 2006 carried no right to a dividend. They were therefore not shares "the holders of which have a right to a dividend at a fixed rate" as it is not possible to have a fixed rate of 0% (reliance was placed on *Dyson v Revenue & C*ustoms [2015] UKFTT 131 (TC) ("***Dyson***")). The 30,000 redeemable shares were therefore not excluded from the definition of "ordinary share capital". The ordinary share capital from 2 January 2009 to December 2009 was thus £33,100, of which the Appellants held £33 each. As each Appellant held less than the required 5% during this period, they were ineligible for entrepreneur's relief.

22. HMRC cannot take account of what others believe or understand. The case can only be considered on the issued share capital and the percentage held by the Appellants. HMRC have a duty to charge the tax due under the legislation and are unable to give up the tax because an individual has failed to consider all relevant circumstances or has obtained advice that is incorrect. The appeal should therefore be dismissed.

23. In post-hearing written submissions, HMRC added the following. The relevant legislation seeks to distinguish between "ordinary" capital and capital with characteristics akin to "loan" capital, and it achieves this through a mechanical test. Section 989 ITA 2007 starts with the assumption that "*all* the issued share capital" of the company should be treated as ordinary share capital, but then provides for a limited exclusion. Entitlement to a rate of 0% is in substance no entitlement to a dividend at all, such that the shares have to be treated as ordinary share capital. The preference shares in this case do not have the leading characteristic of a preference share, which is to carry a dividend that can be preferred or senior. Generally an equity share will carry dividend rights. While the preference shares in this case do not, they nonetheless form part of the capital which is not loan capital and play a role in determining ownership structure. Reliance was placed on HMRC's Employee Share Schemes User Guide, at paragraph ESSUM43230.

The Tribunal's findings

24. The issue in the present case is a narrow one. Section 989 ITA 2007 defines "ordinary share capital" to mean "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". The question is whether the words "a dividend at a fixed rate" in that definition include shares the holders of which have no right to any dividend.

25. If the answer to that question is affirmative, as the Appellants argue, then the 30,000 redeemable shares will be excluded from consideration when determining the Company's issued share capital for purposes of the legislative provisions referred to at paragraphs 13-19 above. The result will be that the Appellants held more than 5% of the ordinary share capital during the 12 month period prior to the sale of the Company, such that they are eligible for entrepreneurs' relief. If the answer to that question is negative, as HMRC argues, this will not be the case.

26. Neither party has suggested that the expression "dividend at a fixed rate" is further defined in the legislation.

27. The Tribunal is not satisfied that the wording of the s 989 ITA 2007 of itself permits only one possible answer to this question. It can obviously be argued, as HMRC does, that a right to no dividend is not a right to "a dividend", and therefore cannot be a right to "a dividend at a fixed rate". However, it can also be tenably argued, as the Appellant does, that a zero rate is a fixed rate, as in the case of a zero rate of VAT. Zero is a number.

28. The Tribunal is conscious of the fact that s 989 ITA 2007 does not define "ordinary share capital" solely for the purposes of entrepreneurs' relief, but for purposes of the Income Tax Acts generally. The same definition appears in s 1119 of the Corporation Tax Act 2010 (see also ss 647(5)(a) and 649(4)(a) of the Corporation Tax Act 2009, s 42(4) of the Finance Act 1930 and s 228(9) TCGA). In the circumstances, the absence of judicial authority on the question seems surprising. The only case relied upon by HMRC is *Dyson*. However, the decision and reasoning in *Dyson* are very brief, which detracts from its persuasiveness. In that case, the First-tier Tribunal simply agreed with the submission of HMRC that "Nothing cannot be said to be a fixed rate".

29. In the circumstances, the Tribunal invited further post-hearing submissions from HMRC on the interpretation of s 989 ITA 2007. However, the HMRC post-hearing submissions essentially repeated the submissions already made. These submissions did however refer to HMRC's Employee Share Schemes User Guide, which provides at paragraph ESSUM43230 as follows:

> "Ordinary Share Capital" is defined in Section 989 ITA 2007. … The following may be accepted as ordinary share capital:
>
> - shares with no dividend rights (we do not contend that they carry the right to a fixed dividend of 0%).

That expression of opinion by HMRC is of course not binding on the Tribunal. However, the wording is curious. It implicitly acknowledges that there is at least an argument that shares with no dividend rights carry a right to a fixed dividend of 0%, since it considers it necessary to address the question. Furthermore, this wording does not state positively that such shares do not carry a fixed dividend of 0%. It simply states that, in the context of employee share schemes at least, such shares "may be accepted" as ordinary share capital, as HMRC will "not contend" to the contrary. This form of wording could be taken to suggest that share with no dividend rights may be treated as having a fixed dividend of 0% for certain purposes in certain contexts, but not others. It is unnecessary to seek to determine here whether that is the case.

30. At the hearing, the Tribunal invited submissions on the circumstances in which, and the purposes for which, a Company would typically issues shares "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". Mr Corbitt for HMRC accepted that the circumstances of the present case could be considered a typical situation. If Mr and Mrs Pennick's loan

had not been made interest free, then the shares could have been issued with a fixed dividend of a positive amount. The fixed dividend would in effect have been the interest on the loan, and the redemption of the shares in due course would have amounted to repayment of the principal.

31. The Appellants argued in response that if that is so, there is no reason for treating an interest-free loan any differently to a loan that is subject to interest. The Tribunal considers that there is much force in that argument, at least in the particular circumstances of this case. It seems that there is no reason why each of the redeemable shares could not have been issued with a right to a fixed dividend of a purely nominal amount (say, a dividend of one fifteen thousandth of a pound per annum per share, such that Mr and Mrs Pennick would have each received a dividend of £1 per annum in respect of their redeemable shares). Had that occurred, the redeemable shares would have been shares giving the holder a right to a fixed dividend, and would not have been treated as part of the ordinary share capital of the Company. It is difficult to see why the redeemable shares in the present case should be treated any differently when the only difference is that instead of bearing a purely nominal fixed dividend, they bear a zero dividend.

32. The Tribunal is sympathetic to the situation of the Appellants. There would have been no question as to their entitlement to entrepreneurs' relief if the redeemable shares had not been created. They were only created at the insistence of Invest NI. They were intended to change nothing of substance, save to ensure that the £30,000 loan from Mr and Mrs Pennick would not be repaid before a stipulated time (March 2009). It seems that it could not have been foreseen at the time that the redeemable shares were created in June 2006 that they would have future implications for entrepreneurs' relief, since the entrepreneur's relief provisions became law only in 2008 (by virtue of the Finance Act 2008). It would seem that if the potential future consequences for entrepreneurs' relief had been foreseeable, other ways of achieving the same purposes could have easily been found that would not have had those consequences.

33. It is true that many transactions may be affected by future changes in tax legislation in ways that are unforeseeable at the time of the transactions. The fact that such unintended consequences have arisen is not a reason for departing from the ordinary rules of statutory interpretation. However, in cases where the meaning a statutory provision is not plain, considerations of common sense may be relevant under ordinary principles of statutory interpretation. There has been no suggestion by either party that any other principles of statutory interpretation could provide an answer to the issue in dispute. No *Pepper v Hart* materials have been referred to, nor any other material as to the policy intentions behind the particular wording of the definition of "ordinary share capital" in s 989 ITA 2007.

34. In short, the Tribunal finds that in relation to the question before it, there is some ambiguity in the wording of the definition of "ordinary share capital" in s 989 ITA 2007. On the very limited information before it, the Tribunal is persuaded that in the particular circumstances of the present case, a right to no dividend is a right to a dividend at a fixed rate for purposes of that definition. The Tribunal does not need to

determine whether the answer would be the same in all other contexts or circumstances (compare paragraph 29 above). No explanation was given to the Tribunal by HMRC as to the possible implications of the answer to this question in other contexts.

Conclusion

35. For the reasons above, the appeal is allowed.

36. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

DR CHRISTOPHER STAKER
TRIBUNAL JUDGE

RELEASE DATE: 5 MAY 2016