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Being aware of alphabet shares

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Winner of
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What we’ll be covering

- General discussion on profit extraction
- Settlements legislation
- Employment related securities (ERS) rules
- Case law and HMRC approach
- Other scenarios

Owner-managed companies – profit extraction

- Salaries – CT deductible but NICs apply
- Rent – CT deductible, NICs do not apply
- Pension contributions – CT deductible, subject to ‘spreading’ rules
- Loans to participators – s455 tax, NICs may apply
- Dividends can be a flexible way to extract profits, including across different shareholders but care required:
  - Income tax could arise to a 'settlor'
  - Recipient may become taxable under earnings or employment related security rules

Dividend tax rates

Dividend tax rates 2024/25

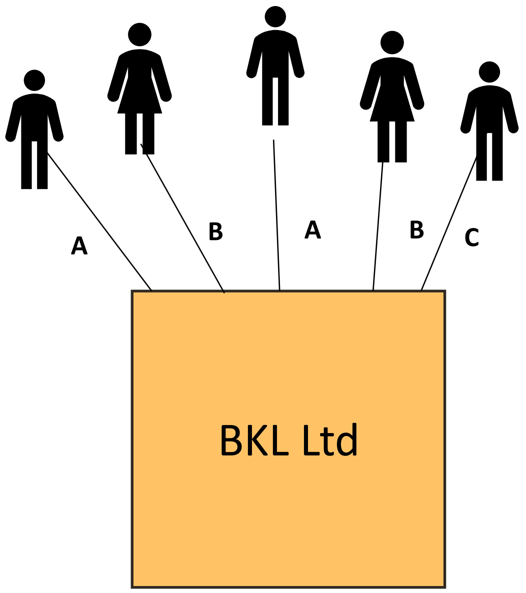
Band *	Income tax
£500 Dividend allowance **	Nil
Basic rate	8.75%
Higher rate	33.75%
Additional rate	39.35%

* Treated as top band of income

** £5,000 to 2017/18, £2,000 to 2022/23, £1,000 for 2023/24

What are alphabet shares?

- Ordinary share capital split into lettered subdivisions
- Provide flexibility over profit extraction
- Rights attributable to each class can differ:
  - Timing of payments
  - Allocation of distributable reserves across different share classes
  - Voting rights
  - Other rights e.g. capital on an exit
- Companies often use separate shares classes for employee share schemes i.e. for commercial purposes, to retain and incentive staff



Why are alphabet shares in the spotlight?

- Historically, dividends have been tax-efficient
- From 2025/26, directors of close companies will be required to state the percentage of capital owned and dividends received
- Data collection to better target administration and policy, and focus compliance activities
- HMRC Spotlight 62 has focused on family planning arrangements e.g. ‘School fees’ structuring which may involve alphabet shares
- High profile cases
- **Note** – legislation allows different classes of share e.g. CSOP changes FA 2023 and BADR conditions (5% ‘economic interest’ tests)

Settlements – HMRC guidance [1/2]

- **Tax Bulletin 64 (April 2003):** ***Businesses, Individuals and the Settlements Legislation***
- *The settlements legislation can apply where an individual enters into an arrangement to divert income to someone else, and in the process, tax is saved.*
- ‘New’ and wider interpretation regarding spouses
- Also …*‘It is a common misconception that the settlements legislation applies only to arrangements involving a settlor's spouse or minor children’*
- Professional bodies had reservations about a number of the examples, especially those involving 'ordinary shares' with capital rights
- Might include partnerships

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Settlements – HMRC guidance [2/2]

- **Tax Bulletin 69 (February 2004):**
- *As with the original article in Tax Bulletin 64, this article sets out the Inland Revenue's view of the way the legislation applies*
- *That view is not accepted by many accountants and tax practitioners*
- Reiterates views in Tax Bulletin 64
- See also LNB News 18/11/2004 68 – A guide for small business advisers (21 examples did apply, and 10 where they did not)
- Case law has changed some of the views – see TSEM
- 'Income shifting' consultation document published 6 December 2007

Alphabet shares – settlements legislation [1/4]

- Legislation dates back to 1938, now in ITTOIA 2005 Part 5, Chapter 5
- ss619 and s619A – Income is treated as the highest part of a settlor's income and income tax charged on
  - S624 – Income where settlor retains an interest in the property
  - S629 – Income paid to 'relevant' children of a settlor (minor children)
  - S619 – Explains other circumstances
- S620(1) – A settlement includes any '…*disposition, trust, covenant, agreement, arrangement or transfer of assets'* (widely drawn)
- *IRC v Plummer HL 54 TC 1* 'Bounty'

Alphabet shares – settlements legislation [2/4]

- S625(1) Settlor has an interest in property if:
- *'…there are any circumstances in which the property or any related property (income)…is payable to the settlor or the settlor's spouse or civil partner*'
- Not an outright gift
- 'Bounty'
  - Provision of something, without something equivalent in return (TSEM4110: a gift or transfer for less than full value)
  - Not acting at arm's length
  - Purely commercial transactions are outside the scope

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Alphabet shares – settlements legislation [3/4]

/ Exceptions at s624(3) ITTOIA

- This refers to certain exceptions including gifts between **spouses or civil partners**
- Must meet two conditions in s626 ITTOIA 2005
  - Condition A: Gift must carry a right to the **whole** of the income
  - Condition B: Property must not be wholly or substantially a right to income
- Are there conditions attached to the gift?
- Are there any circumstances under which property or related property is payable/applicable to the giver?

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Alphabet shares – settlements legislation [4/4]

- **Gifts to other persons e.g. adult children or other persons?**
- As set out in s624, if the 'settlor' retains an interest in the property from which income arises, the settlements legislation could be in point
- Is there is an outright gift?
- Are there any circumstances under which property or related property (income) is payable to or applicable for the benefit of the settlor or spouse/civil partner?

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Spouse exemption – after the Tax Bulletins

- A earns the fees and another B does little or no work
- **Jones v Garnett [2007] – Arctic Systems**
  - Geoff was an IT consultant
  - Diana dealt with bookkeeping, secretarial and admin work
  - Two issued £1 shares
  - Small salaries paid and substantial dividends 50:50
  - Court of Appeal: there was an ‘arrangement,’ but the element of bounty was missing
  - House of Lords agreed: ordinary shares are not ‘substantially a right to income’

Settlements – HMRC guidance [1/2]

- **Spouse and civil partner companies**
- **TSEM4225:** will normally only invoke provisions where dividends could not have been legally paid across all relevant shares without
  - Dividend waivers
  - Separate share classes
- **Example 13**: Dividends on certain shares (bounteous arrangement)
  - A (Mrs I) and B (Mr I) hold shares 80:20 (rank equally)
  - Profits of £25,000
  - Dividend of £20,000 voted on B shares (20% of the OSC)

Settlements – HMRC guidance [2/2]

- **Other shareholders including adult children**
- **TSEM4200 (Example 3)**
- Mr C wants to give brother a gift (but avoid higher-rate charge)
- Mr C transfers 50 (of 100) shares to brother but on the understanding they will be given back
- Pays a pro-rata dividend (£25,000 each)
- Settlor retains an interest

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Settlements - dividend waivers

- See **TSEM4225**
- **Buck (2008)** Mr Buck had 9,999 shares and wife had 1, settlements did apply re waiver by Mr Buck and payment of dividends to wife only
- Not an outright gift
- **Donovan and another (2014)** Wives and husbands paid dividends at different times
- Insufficient distributable reserves was not conclusive, but decided there was a lack of commercial purpose
- Unconnected shareholders more unusual to find waivers unless there is a genuine commercial reason

Settlements – other scenarios

- Family partnerships
- TSEM4215 – Cases where family members share profits on a basis not fairly reflecting the contribution by each
- PM132400 – For spouses and civil partners must not be a right to income
- Rental income – PIM1030 can agree different shares but care re settlements rules

Settlements – summary

- **Spouses and civil partners:** recommend that dividends are paid into separate accounts to limit the risk of HMRC arguing dividends end up back in hands of settlor
  - Thin shares – see Buck
  - Even if both had held different classes, in principle there is a gift of income if dividends are paid disproportionately
  - Dividend-only shares, not recommended (no capital)
  - Gifting shares and regifting back, not recommended
- **Others:** Must be an outright gift with no way transferor will receive any benefit
- **Waivers:** Distributable reserves should be reviewed and the commerciality of arrangements considered

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Employment related securities (ERS)

- Rules in **ITEPA 2003**
- Two main issues relating to the acquisition of shares:

1) **Award** itself may have income tax implications i.e. ‘earnings’ under s62 ITEPA 2003, and/or ITEPA, Part 7 applies
   - Value of what received less amount paid unless under a tax-advantaged share scheme e.g. EMI/CSOP
2) **Rights** attaching to shares
   - ERS rules in ITEPA 2003, Part 7 mean there are other circumstances when charges can apply to restricted securities
   - When restrictions are lifted or shares are sold, there may be additional charges (unless s431 election made)

ERS and shares from employment

- **Share acquisitions**
- Income tax on acquisition actually arises under s62 ITEPA 2003 (earnings)
- Emolument from the employment
- ERS rules talk about ‘by reason of employment’ for Part 7 ERS rules
- Shares acquired ‘by reason of employment’ may not be earnings
- *Fine line between ERS and shares from employment* – David Whiscombe’s article for Tax Journal, available on our website
- ITEPA 2003, Part 7 Chapter 3C applies, notional loan which is discharged in future e.g. when shares are disposed of to a third party

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ERS – family members

- Deeming rule at s421B means ERS implications for most employee-held shares
- 'Employment' is defined widely
- Exemption at ITEPA 2003, s421B(3) ‘normal course of domestic, family or personal relationships’
  - Shares must be transferred (CGT, but gift holdover relief may be available)
  - If a large number of employees, including family members, are given shares, HMRC likely to maintain the exemption does not apply
- Where shares gifted to family members, they remain ERS - the scope of the exemption is not as generous as assumed
- ERS rules cease to apply in certain circumstances eg a sale of the shares to a third party.

ERS and dividends [1/2]

- **Chapter 3B, Part 7, ITEPA 2003** (non-commercial increases in value)
- Capture tax that might have been avoided due to artificial changes in value
- **s446K(1) ITEPA 2003** *"…things done otherwise than for genuine commercial purposes."*
- Uplift in value by more than 10%
- Valuation date is 5 April each year
- **ERSM60030** – declaration of dividends
- Shares increase in value on the declaration of dividends
  - Possible **double charge** to tax, on dividends and increase in value as employment income and exposure to NICs

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ERS and dividends [2/2]

- **Chapter 4, Part 7, ITEPA 2003** (post-acquisition benefits from securities)
- **Dawn Primorolo (2005):** *'…Section 447 of the 2003 Act has been carefully designed to target complex, contrived avoidance arrangements that are used mainly to disguise cash bonuses .'*
- **ERSM90060:** *'Where…there is no contrived scheme to avoid Income Tax or NIC on remuneration or to avoid the IR35 rules, HMRC will not seek to argue that a **Chapter 4** benefit has been received by the directors because of the exclusion provided by ITEPA03/S447 (4)'*
- More likely 'earnings' under s62 ITEPA 2003

ERS – dividend only shares [1/2]

- *PA Holdings [2012] STC 582*
- Complex case
- Payment that is of its nature earnings should be taxed as earnings
- Rights attaching to shares must genuinely be a dividend rather than payment for services performed
- Shares with no voting rights or rights to capital are more susceptible, especially if forfeitable by leavers

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ERS – dividend only shares [2/2]

- Whether paid as a return on capital or a receipt for services will depend on the facts of the case
- **ERSM60030** – Alphabet Soup (Example 3)
  - *A company uses special classes of shares to pay all or most of employees' wages as dividends. Each employee will have their own class of shares so different dividends can be paid to each. The shares have no rights other than that the employer can award dividends at his discretion*
- Each dividend is acting as though it were a cash bonus

ERS – dividend policy

- Defences against employment charges
  - Full voting, capital and dividend rights so should not increase value by more than 10%
  - Where have capital and dividend rights, value accrues in capital rights if non-pro rata dividend paid
  - Very large dividends which materially decrease distributable reserves could increase value by more than 10%
- However. charge operates by comparing the market value on **last day of each tax year**
- Position regarding **dividend only shares** should be reviewed

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ERS – quasi partnerships

- Number of co-owners which operates similar to a partnership
- Shares carry full voting, dividend and capital rights
- For one year, a shareholder receives an additional dividend amount
- ERS rules could apply if this is connected to the work carried out by the shareholder
- If carry full equity and voting rights, ***potentially*** distinguishable from dividend only type shares which are more aggressive
- Risk of NIC?
- Changing share rights to reflect work the shareholder has done could have ERS implications (and CGT!)
- Proceed with a degree of caution

Other – family investment companies (FICs)

- HMRC Taskforce
- Shares issued to family member and gifted to a trust for minor children
- A lot of recent press regarding school fee planning
- Spotlight 62
- Cover in a later session

Common misconceptions

1. HMRC guidance on settlements is not as widely drawn as often assumed
2. TSEM4355 ‘In most everyday situations…the settlements legislation will not apply’ (see examples)
   / No bounty, or
   / For spouse or civil partner not wholly or substantially right to income
3. ERS rules: s62 takes priority if shares are ‘from’ the employment
4. ERS alphabet shares – note the date of valuation for the purposes of the 10% test

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Summary

/ HMRC will be gathering more information

/ ERS reporting (6 July) also provides a significant amount of information

/ **Settlements legislation:** particular care required in respect of spouses and civil partners

/ Avoid paying dividends in excess of pro rata share entitlements and use of dividend only shares only if supportable

/ **ERS rules:** No spousal exemptions and ‘family exemption’ is not a given

/ Care needed re rights attaching to shares and dividend policy

Thank you

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