

A FEW POINTS OF INTEREST

By Laurent Sykes QC

Zero rate preference shares

The Upper Tribunal case of *Revenue and Customs Commissioners v McQuillan* [2017] UKUT 344 (TCC) establishes that shares carrying no rights to profits are ordinary shares for the purposes of s1119 CTA 2010 / s989 ITA 2007 – as opposed to 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. Mr and Mrs McQuillan’s appeal succeeded before the First-tier Tribunal but the decision was reversed by the Upper Tribunal which held that no rights to dividends is not equivalent to the right to a dividend at a fixed rate of 0%. The shares in question were the Upper Tribunal considered therefore “ordinary shares” within s989 Income Tax Act 2007.

Mr and Mrs McQuillan were not represented by counsel before the Upper Tribunal, and consequently, the Upper Tribunal did not have the benefit of full legal submissions. The issue in the case was whether shares for UK company law purposes which do not carry any right to profits (whether capital or income) but simply to repayment of the amount subscribed are “ordinary share capital” within the definition which provides that:

“ ‘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”.

The author considers the Upper Tribunal decision to be unsatisfactory and one which is liable to be challenged in future cases. It is perfectly plausible to argue that such shares

are not “issued share capital” within the intendment of the legislation *even if* the Upper Tribunal was right that no right to a dividend is not equivalent to the right to a dividend at a fixed rate of 0%.

In *South Shore Mutual Insurance Co Ltd v Blair* [1999] STC (SCD) 296, a case not cited to the Upper Tribunal, the Special Commissioner (Dr Nuala Brice) stated (with regards to defining the concept of a share for the purposes of the predecessor to s989):

“56. In the light of these authorities it appears that the phrase ‘issued share capital’, while perhaps not a term of art in English law, does embody an idea which Parliament has used in other statute law where the phrase is used to mean that part of a company’s authorised share capital as has been issued. Thus, following the principle in *R v Barnet London BC, ex p Shah* [1983] 2 AC 309, that meaning should be adopted unless it can be shown that the statutory framework, or the legal context in which the words are used, require a different meaning.”

The statutory framework was taken into account by the Privy Council in *Collector of Stamp Assets v Arrowsdown Assets Limited* 6 ITLR 454, where Lord Millett NPJ held the following:

“[157] Section 45 is not an end in itself. The words ‘issued share capital’ in the section, properly construed, mean share capital issued for a commercial purpose and not merely to enable the taxpayer to claim that the requirements of the section have been complied with. It follows that the ‘B’ non-voting shares issued to Shiu Wing are not ‘share capital’ within the meaning of the section, and should be disregarded when calculating the proportions of the nominal share capital owned by Shiu Wing and Calm Seas respectively.”

Statutory context is relevant when in considering whether an instrument is a share for the purposes of the relevant

legislation, still more so given the law in question can apply to a number of different entities formed under the legal systems of a number of different jurisdictions. The words “however described” in the definition cited above indicate that a more searching enquiry is needed than merely considering the legal form.

Construing “issued share capital” as requiring that the instruments in question have a right to profit, is suggested by the wording of the s1119/s989 definition as read in the statutory context. As can be seen from the definition, the carve out “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” implies one of two things: either that shares which constitute “issued share capital” must carry a right to profit of some description so that the carve out in s989 (beginning “other than”) does not need to apply to shares which carry no rights to profits, or that shares which have no rights to profit are “ordinary share capital” and the carve out is specifically aimed (for an uncertain legislative purpose) at shares which carry a right to dividends at a fixed rate (but not to shares which carry no rights to profits). In deciding which of these constructions is correct, regard must be had to the purpose of the legislation.

The definitional term “ordinary share capital” denotes a right to participate in profit. Although the term is a defined term, that sheds light on the meaning of the words which it defines (see *Dextra v McDonald (Inspector of Taxes) v Dextra Accessories Ltd* [2005] UKHL 47 per Lord Hoffmann at [18]). A share which carries no rights to profits is as far from being an ordinary share as it is possible to get and the stark contrast between the defined term and the definition itself, on one of the two possible constructions, is relevant in construing the definition.

The Special Commissioner’s decision in *South Shore Mutual* supports this construction. She said:

“[59.] With those principles in mind it is now possible to return to the words ‘issued share capital (by whatever name called)’ which appear in s 832(1). The phrase is open to two possible interpretations. The first, and narrower, interpretation is that the phrase means such authorised share capital of a company as has been issued, whether or not it is called ordinary share capital, so long as it gives a right to a share in the profits. This interpretation follows from giving the ‘normal’ meaning to ‘issued share capital’ but ensuring that it is not limited to issued share capital with any particular name. So, for example, it could include issued preference share capital. The second, and wider, interpretation, is that for which Mr Peacock argues and is that the phrase includes anything that can be identified as being ‘issued’ and ‘share’ and ‘capital’. This interpretation follows from allowing the phrase ‘by whatever name called’ to govern the meaning of ‘issued share capital.’”
(underlining added)

Having regard to the wider statutory context, it appears fairly clear that the purpose of s989 is to exclude, from the definition of ordinary share capital, shares which have no right to a share in profits other than a right to dividends at a fixed rate, rather than to include within the definition all shares (even those with no right to a share in profits) but then to exclude shares which have a right to dividends at a fixed rate. Shares with no rights to profits are more akin to shares with only a right to a dividend at a fixed rate. The definition of ordinary share capital is used to delineate owners of the equity of a company for the purposes of a number of different rules (including entrepreneur’s relief, group relief, capital gains grouping etc). All of these are concerned with economic ownership. That purpose would be manifestly flouted if one could increase a right to ordinary share capital by subscribing for shares with

no right to profits at all. It is no answer to this to say that there are, in some of these provisions, other requirements which must be satisfied (a point relied on in *McQuillan*). The issue is this specific requirement and why Parliament could have intended it to be met by rights such as the ones discussed.

It can be argued that shares with no rights to profit are not “issued share capital” for these purposes. Alternatively the words “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” in context should be construed as meaning “other than capital the holders of which have no right to share in the company’s profits beyond a right to a dividend at a fixed rate”. In other words, shares which do not carry a right to profits are within the carve out even if they do constitute “issued share capital”. Support for this is to be found in the *South Shore Mutual* case and it fits the statutory context for the reasons set out above. If those two interpretations are wrong, then it is considered that the analysis adopted by the First-tier Tribunal in *McQuillan* with respect to the shares carrying a right to dividends at a fixed rate of zero is correct.

The Upper Tribunal considered that there was no ambiguity in s989 ITA 2007. However, the question of ambiguity is not a matter which is settled by looking at the words of legislation in isolation. Ambiguity can arise where the clear meaning of words enters into conflict with their surrounding context (see for instance *Bryan Francis O’Rourke (H.M. Inspector of Taxes) v Edward Binks* [1992] STC 703 at 707-708). The view of that Upper Tribunal at [35] that “there is in our view no possible recourse in this case to the spirit of the legislation” puts the position too strongly, and it is a shame that the position was not tested more fully.

Attributing loss to a failure to notify

Unless a notice is received under s8 TMA 1970, every

taxpayer is under an obligation to notify HMRC within 6 months of the end of the tax year if they are chargeable to income or capital gains tax (s7 TMA). The same is true of companies (para 46(2A)(b) Schedule 18 FA 1998). HMRC's power to raise an assessment where a loss of tax is "attributable" to a failure to notify is wide. Such an assessment can be raised up to 20 years from the end of the tax year to which the assessment relates¹.

Suppose that the taxpayer did not take advice on a particular matter arising in year X and has no defence to an assessment under s36 (or, in the case of companies, para 46) as a result of the taxpayer's failure to notify but that, on another matter arising in the same tax year, the taxpayer did take and relied upon advice to the effect that no liability arose with respect to that other matter. Can HMRC assess the tax in respect of this other beyond the usual four – year time limit in the way they can assess tax arising from the first-mentioned matter? The better answer is that it cannot be said that the tax arising in relation to the second matter is attributable to the failure to notify.

As a matter of ordinary language, a loss will only be so attributable if it has been *caused* by the failure to notify (see *James Fuller v HMRC* [2020] UKFTT 189 (TC), in particular, at [50]; see also *Glasgow Coal Co v Sneddon* (1905) 7 F 485 per Lord McLaren at 487 for a similar interpretation of the word 'attributable' in a different context). As a matter of general law, the question of causation requires the positing of a hypothetical scenario. In these circumstances, the scenario is one in which the taxpayer *has* notified HMRC of their chargeability. Working through that scenario, the next question is what the hypothetical taxpayer would have reported in their tax return. The hypothetical taxpayer must be deemed to be reasonable (see, for example, *McWilliams v Sir William Arrol* [1962] 1 WLR 295 per Lord Reid and 306) but not omniscient

in tax matters. It is very likely that they would have relied on professional advice received (see *Fuller* for confirmation of the relevance of ‘likelihoods’). Indeed, there is a presumption that such advice will be causative (*Levicom International Holdings BV v Linklaters* [2010] EWCA Civ 494 per Jacob LJ at [284]).

It may on the facts be that the loss of tax would have arisen whether or not there had been a failure to notify. In other words, the loss of tax is not “attributable” to the failure to notify. The presence of a loss of tax and a failure to notify are not, *per se*, sufficient. Where the relevant conditions are satisfied so as to permit the assessment of tax in relation to one matter, that does not mean all matters are open to extended time limits.

Document retention obligations

The case of *McMillan v HMRC* [2020] UKFTT 82 (TC) is a useful reminder of the primary burden of proof that rests on HMRC. A discovery assessment, as the words suggest, requires HMRC to have “discovered” a loss of tax (s29 TMA 1970; for companies para 41 Schedule 18 FA 1998). It is not sufficient that the taxpayer’s evidence as to the source of funds is doubted; the obligation is on HMRC to show that there is a loss of tax. Inherent within that is an obligation to show that the taxpayer has derived funds from a taxable source on which tax should have been paid.

In *McMillan*, the taxpayer had been a very successful gambler between 1998 and 2010. To avoid attention, for reasons unconnected to tax, the money had been paid in cash into a number of bank accounts over several years in small amounts. HMRC were suspicious and raised assessments.

Records of the gambling had not been kept beyond the period required by s12B TMA (until the first anniversary of 31 January following the year of assessment). That document retention obligation is recorded in HMRC’s Self-Assessment Guidance (at CH14550). HMRC’s reliance on *Brimelow v Price*

(1965) 49 TC 1, to rely on the absence of records as meaningful was accordingly rejected. The burden required of HMRC was not discharged and the absence of records was of no automatic assistance to them. HMRC could not point to an alternative to the taxpayer's explanation as regards the source of the funds, which was accepted.

The case is also interesting in that the review officer's conclusions (that the assessments should be vacated) had been changed following the intervention of the inspector. This was discovered because the wrong review letter was included by HMRC in their list of documents. This casts doubt on the independence of the review process.

The availability of Treaty benefits for remittance basis users

The Italian Supreme Court has recently concluded (in the case of *Tiziano Ferro* (judgment No. 21696 of 8 October 2020)) that a remittance basis user was not UK Treaty resident. The decision in that case was strictly not decisive as the court had already concluded that the change in residence from Italy to the UK was purely fictitious. However, the comments are concerning for those claiming the remittance basis in the UK and claiming treaty benefits in the state of source.

Most fundamentally, the Italian Supreme Court appears to have confused being "liable to tax" and being "subject to tax". In the domestic context, the distinction is reflected in *Weiser* [2012] UKFTT 501 (TC), in line with case law of other jurisdictions. The Supreme Court's reliance on the fact that no UK tax was ultimately paid on foreign source income as the income had not been remitted was misplaced.

A remittance basis user who *does*, in contrast to the taxpayer in *Tiziano Ferro*, remit funds would be "liable for tax" following the logic of the Italian Supreme Court. Funds, once remitted, do not automatically develop a UK source. So, a remittance basis user who remits, say, £100 to the UK would be a "resident"

of the UK for treaty purposes. However there is no such concept as partial residence. It would be bizarre if a remittance so small could have such a significant effect. The correct position is that a remittance basis user is liable for tax on foreign source income even if no tax is paid.

Whilst treaties need to be interpreted in light of their purpose (the elimination of double taxation and abusive double non-taxation), there is nothing abusive in opting to be taxed under a beneficial tax regime; particularly where that regime existed and was known about prior to the treaty being signed (see, for example, *MIL (Investments) SA v Canada* 9 ITLR 25 at [73]). Further, there is a real risk of double taxation on the approach adopted by the Italian Supreme Court as the UK will only give a credit for foreign tax paid in accordance with the Treaty.

The relevant part of the decision in *Tiziano Ferro* is short but concerning. It is hoped that the error can be corrected in due course. It is of note that the Italian authorities believe that an Italian resident paying the Italian flat tax for non-Italian income would be a resident of Italy for treaty purposes. There appears to be an inconsistency of approach.

Endnotes

1. Subject to the application of s118 TMA 1970.