

Tax planning using 'alphabet shares'

(Lecture B1087 – 15.07 minutes)

Introduction

Companies are traditionally formed with a nominal number of ordinary shares. These typically give the shareholder rights to dividends, the right to vote at Board meetings and the right to a share of the assets on a winding-up.

Dividends are paid equitably in proportion to the shares held. This means that shareholders with the same number of ordinary shares are entitled to the same dividend. This might not be ideal in a family situation where one shareholder is a higher-rate taxpayer and the other is not as the payment of a dividend could trigger an income tax charge at 32.5% or 38.1%. This can be dealt with to a certain extent by a dividend waiver, but as explained in a separate lecture, waivers can bring the settlement rules into play and the over-use of dividend waivers is not recommended. In addition, a formal Deed of Waiver needs to be executed every time a shareholder wishes to give up their right to a dividend (which can be laborious and costs money).

A more effective long-term solution is to use so-called 'alphabet shares'.

What are 'alphabet shares'?

Alphabet shares are different types of share classes that are denominated by a letter - for example, "A" Ordinary shares, "B" Ordinary Shares", "C" Ordinary Shares" etc. The main purpose behind alphabet shares is to enable the company to pay dividends to shareholders of differing amounts and at different times (which isn't possible with standard, generic ordinary shares of the same class). Typically alphabet shares will give the company flexibility to vary the amounts of dividends paid to husband and wife shareholders. Using alphabet shares to create an income stream for a university-bound 18 year-old is also not unheard-of.

There is no need for a shareholder to waive any dividend rights because a dividend declared on a 'B' share would have no bearing on the holder of an 'A' share or a 'C' share. Paperwork and costs are duly reduced.

The rights attaching to these shares are normally found in the company's Articles of Association. However, the rights can also be specified by a separate contract such as a Shareholders' Agreement.

Not all alphabet shares have to carry the same rights, therefore different rights or restrictions can be attributed to alphabet shares as required. It is therefore very important that the rights attaching to alphabet shares are clearly established and that all shareholders are aware of what rights their alphabet shares carry.

If a company wishes to pay dividends on one class of shares to the exclusion of another, or if dividends are to be paid on both classes but in different amounts, a clause or article to this effect must be in evidence. Standard model articles are unlikely to be fit-for-purpose in these situations so proper advice should therefore be sought to ensure that the I's are dotted and the T's are crossed before a dividend strategy is put into effect.

Secretarial agencies can prepare the paperwork for as little as £200 to ensure the formalities are in place. This will include appropriate articles and necessary board resolutions to confirm that dividends can be independently declared on each class of ordinary share.

The Settlements Rules

Before alphabet shares, the weapon of choice was often non-voting preference shares which carried a right to a dividend but (as the title suggests) little else. However this route is no longer effective following *Young v Pearce* and *Young v Scrutton* (1996).

In these cases (heard together) the diversion of income via newly issued preference shares to the lower-tax paying spouses of the existing shareholder / directors was held to be a gift of a right to income. As the arrangement was bounteous and in favour of a spouse, under the settlements code (in what is now S.624 ITTOIA 2005), the income of the settlement – in this case the dividends paid to the wives – was taxed on the settlors (the husbands). The “get-out” provision of S.626 did not apply as there was no outright gift of an asset to a spouse. The gift was of a right to income as the preference shares carried only dividend rights.

HMRC can use the same mantra to challenge alphabet shares if the shares are merely a conduit through which to pay a dividend to a spouse (or minor child), the shares do not carry any capital / voting rights and the alphabet shares would not have been issued to a third-party on an arms’ length basis. Therefore, advice when using alphabet shares is to ensure that the shares issued to a spouse are not restricted in terms of voting power or capital returns on a winding-up. The spouse’s shares should therefore carry the same rights as the ordinary shares held by the other spouse.

As an aside here, one should keep in mind that entrepreneurs’ relief (ER) will only be available on a disposal of the shares where the individual holds at least 5% of the ordinary share capital (tested by reference to the nominal value of the shares in issue) and is able to freely exercise at least 5% of the voting rights. Shares carrying dividend rights only would not be eligible for ER.

To avoid these settlements rules, other issues should also be borne in mind when using alphabet shares:

1) Make sure the company has sufficient distributable reserves.

HMRC can deem the issue of alphabet shares to be a bounteous arrangement in favour of a spouse where a dividend on the spouse’s “B” shares could not have been met from reserves without fellow shareholders receiving a zero or negligible dividend.

For example, assume Mrs. H owns 80 ordinary ‘A’ shares in H Ltd. Mr. H owns 20 ordinary ‘B’ shares. The shares carry the same rights and rank equally. In 2018, the company made a profit of £25,000. A dividend of £20,000 is voted on the ‘B’ shares while no dividend is voted on the ‘A’ shares.

By not voting dividends on the ‘A’ shares (which rank equally with the ‘B’ shares), this is a bounteous arrangement as the dividend paid on the ‘B’ shares could only be paid if no dividend (or a very low one) was declared in respect of the ‘A’ shares. Part of the dividend paid to Mr. H is attributed to Mrs. H under S.624 ITTOIA 2005 because the decision only to vote dividends on certain shares was a bounteous arrangement.

[Example taken from HMRC Trusts, Settlements and Estates Manual at TSEM4225.]

2) Demonstrate that the spouse plays an active part in the business.

This adds a degree of commerciality to the arrangement that is helpful when trying to defend an assertion that the arrangement is bounteous.

Employment issues

The low-salary / dividend top-up strategy is well known. It utilises personal allowances, basic rate bands, dividend allowances and NIC thresholds at a very low effective rate of tax. It is also perfectly acceptable tax planning if it is done correctly.

Where alphabet shares are used to pay dividends to employees, it is important to ensure that those employees receive wages at or above the national minimum wage. The salary must not therefore be so low as to contravene NMW rules. For a full-time employee working (say) 35 hours a week, this means that paying a salary at or below the level of the personal allowance or the primary Class 1 earnings threshold might not be sufficient. [NMW does not apply to directors unless the director has an employment or service contract.]

A major consideration with issuing shares of any description to an employee or director is compliance with the rules on employment-related securities (ERS). Assuming that the shares are not issued as part of a tax-advantaged scheme – highly unlikely with alphabet shares – the employee will have a taxable benefit equal to the value of the shares issued. Any amounts paid for the shares reduce the taxable benefit.

In cases where the shares carry no rights other than the ‘hope’ of a dividend, this value will be low reflecting the difficulty in being able to sell the shares to a third party. But even in cases where the shares have no value so no taxable benefit arises, the majority of share issues must be reported using HMRC’s online portal (the electronic form 42) by the following 6 July. This enables HMRC to raise any questions which they feel need raising.

However, the issue of shares (or the allotment of further shares) by a newly incorporated company is not a reportable event. The founders of a company can set it up with any type of share capital they choose. Once a founder has subscribed for his shares, any dividends paid on those shares are taxed as dividends because the source of the income is the share ownership. This fact is not altered if the subscriber subsequently becomes a director or employee.

So, establishing the family company with equal-right alphabet shares for different shareholders is good practice.

There is similarly nothing wrong with a husband and wife forming a company under which H has ordinary ‘A’ ‘B’ ‘C’ and ‘D’ shares and W has ordinary ‘E’ ‘F’ ‘G’ and ‘H’ shares etc, as this then allows a tax free (and form 42 free) gift of those shares to their children down the line. The transfer by an individual of shares “in the normal course of domestic, family or personal relationships of the person transferring the shares” is not reportable and does not trigger any taxable benefit by virtue of the get-out in S.421B. There needs to be demonstrated that there is no element of remuneration in the award or grant - i.e., the transfer is by the familial relationship rather than the shares being offered as an employment reward. So, setting up an alphabet structure then transferring those shares to family members should bring with it no employment issues whatsoever.

Assuming the company is trading, any gains issues (and any possible value-shifting issues) can be taken care of with a gift relief claim (using form HS 295).

The ERS legislation in ITEPA 2003

Alphabet shares have been used by employers to pay targeted dividends to employees to reduce income tax and avoid PAYE and NIC. The dividend is paid in lieu of wages or bonuses. Umbrella companies have been using this strategy for a while.

This is typically achieved by creating a separate class of shares for each employee which only carry a right to a dividend. The taxable benefit on the share issue is negligible (these shares having no re-sell value). The settlement legislation is not in play because even though this is a bounteous arrangement, the beneficiary is not the spouse or minor child of the person doing the arranging. IR35 issues are avoided as the shareholders do not have a 5% interest in the corporate umbrella.

But – naturally – HMRC do not like it and can use ERS legislation in ITEPA 2003 to argue that the dividend income – being de-facto employment income – should be taxed under PAYE and subjected to NIC.

There are two angles of possible attack, both under Part 7 of ITEPA 2003 (“Employment Income: Income and exemptions relating to securities”).

The first is S.446K ITEPA 2003 under which employment income charges can arise where value is realised by artificial increases to the value of securities. HMRC use the example of a company using 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 if it were a cash bonus specific to the employee. Each time the dividend is voted, the value of the share will rise and each time the dividend is paid, the value will fall again. The accumulated rises for the year will be artificial increases in value of the shares. As this is not for a commercial purpose, the increase in value – being the amount of the dividend - is treated as employment income. The fall-back in value is ignored. HMRC have nick-named this “Alphabet Soup”. [See HMRC ERSM60030.]

The defences against this attack are that:

1. Shares issued to family are protected by the “domestic and family” exemption in S.421B and this rules out any charges under the ERS code; and
2. If the alphabet shares have full capital and voting rights, there is no such artificial increase in value every time a dividend is declared.

There is also the second argument that where different classes of shares are issued to employees, any benefits received in relation to those shares are caught under S.447 ITEPA as “post-acquisition benefits from employment-related securities”.

This legislation applies where the shareholder has received shares after becoming an employee. HMRC’s argument is that the employee’s shares are ‘employment-related’ and that the dividend is therefore a post-acquisition benefit.

This argument is more difficult for HMRC to get across the line and their guidance at ERSM90060 suggests that HMRC is more likely to try and apply S.447 to “contrived” arrangements by composite companies paying dividends to its contracted workers in place of income subject to PAYE and NICs. Alphabet share strategies used by umbrella companies to avoid PAYE and NIC on distributions to their contractors might therefore be vulnerable.

Conclusion

As with dividend waivers, the use of alphabet shares to pay dividends in a tax-efficient manner is acceptable and valid planning if it is done with care and some fore-thought.

Avoid the settlements rules by either retaining full rights for alphabet shares issued to spouses or make sure that there are sufficient distributable reserves to meet a dividend on shares in the other classes.

And avoid any “smoking guns” linking dividend payments to employees with rewards for services as HMRC can use ERS legislation to recategorise what should be dividend income as employment income.

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