

Dividend waivers – yes they do still work!

(Lecture B1086 – 11.07 minutes)

Introduction

When a company declares a dividend on a class of shares, the proceeds must be distributed to the shareholders in proportion to the number of shares held in that class at the date the dividend is announced.

This may not be desirable from a tax perspective as it could create a higher or additional rate liability at 32.5% or 38.1% for a shareholder who probably has no pressing need for the cash in the first place.

The solution is therefore a dividend waiver whereby one or more shareholders give up their right to the dividend thereby enabling more of the profits of the company to be distributed to either:

- Family shareholders with lower marginal tax rates and/or unused dividend nil bands; or
- Employee shareholders in place of remuneration which would otherwise be taxable (and NICable) as earnings.

The tax advantages are therefore clear to see. However to avoid challenge from HMRC, certain procedures must be followed when considering a dividend waiver.

Deed of Waiver

As in all successful tax planning arrangements, the paperwork must be in order.

Dividends can only be waived by a Deed of Waiver. The Deed of Waiver must be formally executed and signed by all shareholders who are exercising their rights to give up their dividend entitlement. The Deed is then retained by the company.

In the good old days, it would have been sufficient for the FD or the company accountant to organise this with some simple basic wording along the lines that:

“...I, Fred Bloggs of 7 Acacia Avenue being the registered holder of 1,000 £1 Ordinary shares in Bloggs Trading Ltd hereby waive all rights to the final dividend of £100 per share declared by Bloggs Trading Ltd on 16 August 19XX in respect of the accounting period ended 31 March 19XX....” (or words to that effect).

The Deed would be witnessed by someone in the office, popped on file and Bob, as they say, is your uncle.

But things are different in our new modern world and stuff we would have gotten away with in times gone by are no longer allowed. The preparation of a Deed of Waiver is a “reserved legal activity” under the Legal Services Act which means that only those who are members of the Bar or the Law Society (or who work for an employer who is authorised as such) are entitled to draw up such Deeds. So, in short, we now need to pay

a fee to a solicitor who will pull-up a standard template from his server – no doubt with wording not dissimilar to that above – and charge us accordingly. [A careful read of the firm’s PII policy might reveal that the business isn’t covered for having a stab at the legal stuff, so all this is probably for the best.]

Without wishing to be a doom-monger, preparing a Deed of Waiver (or similar legal document) for a client without being properly authorised is a criminal offence with a prison sentence of up to two years and/or a fine. There are defences along the lines that the person did not know and could not reasonably have been expected to know that an offence was being committed. However this may now be a difficult argument to sustain giving that you are currently reading an article that warns you of the dangers of doing this, so enough said.

Create some commerciality

A dividend waiver should be used for genuine commercial reasons and, as we know, the desire to avoid or mitigate tax does not tick this box.

Paying out less of the distributable profits by way of dividend enables the company to retain funds to use for a specific or earmarked purpose. Therefore, if a shareholder decides to assist the company in this regard, his motives – and the specific purpose for which funds are being retained – should be recorded.

In *Donovan & McLaren v HMRC (2014)* the director / shareholders engaged in a series of dividend waivers so that their spouses could utilise their personal allowances and basic rate bands (instead of the dividend being taxed on director / shareholders at higher rates).

The First Tier Tribunal rejected Mr Donovan & Mr McLaren's contention that they had waived their rights to the dividend in order to maintain cash reserves in the company for the purpose of funding the purchase of a freehold property. The First Tier Tribunal said that this could have been more easily achieved by voting a smaller dividend. The First Tier Tribunal held that there was no commercial reason for the dividend waiver, the waiver would not have taken place on an arm's length basis and the arrangement was entered wholly for the purpose of reducing the tax liability of the taxpayers' families. As such the waivers fell within the settlements rules making them ineffective for income tax (see more on the settlements rules below).

As an aside, the First Tier Tribunal also concluded that discovery assessments could be made in this case to collect the tax as none of the tax returns disclosed the fact that dividend waivers were in place. This suggests that shareholders who have executed dividend waivers and want protection against discovery assessments ought to include relevant information relating to the dividend waiver in the appropriate white space box.

Watch your timing

The Deed of Waiver must be in place before the right to receive a dividend arises. For interim dividends, this is the day before the dividend is paid.

For final dividends, this is the day before entitlement to the dividend arises (normally at the AGM) because at that point the shareholder has a legally enforceable right to the declared dividend.

In short, once the dividend is "unreservedly placed at the shareholder's disposal" – for example by credit to a loan account - there is no going back.

Don't create a "settlement"

HMRC has been using the settlements legislation in ITTOIA 2005 to attack income shifting in family businesses for decades. I first came across it in the early 90's (when the attack was under S.660A ICTA). So whilst the statutory authority has relocated to a different Tax Act, the technical argument is nothing new.

The argument is as follows:

- A planning scheme to divert income to a family member is a bounteous arrangement which falls within the statutory definition of a "settlement";
- Where a settlement is made by an individual and the persons benefitting from the settlement are his spouse and/or minor children, the income of the settlement is taxed on the settlor; therefore
- Income which is diverted to a spouse by means other than the outright gift of an asset would effectively bounce-back and remain taxable on the settlor.

HMRC apply the same idea to dividend waivers where one spouse waives their rights to a dividend thereby enabling the company to pay a higher dividend to their spouse. The waiver does not constitute the gift of an asset (it represents a right to income), so there is no protection under S.626 (or under the Artic Systems logic).

However, HMRC will only attack dividend waivers under the settlements rules where the arrangement is “bounteous”. Not all dividend waivers are bounteous. For example, if A and B are 50% shareholders and A waives his right to a dividend, it doesn’t follow that B receives an increased amount. B’s dividend is the same. There is the argument that the company now has more cash in the bank making it worth more thereby increasing the value of B’s 50% share, but the IHT legislation deals with this in S.15 IHTA 1984 by saying that no transfer of value takes place.

The “bounty” test here is whether, on occasions where a dividend waiver has taken place, there would be sufficient retained profit to pay the dividends on the shares which are subject to the waiver. If there isn’t, there is bounty and this brings the settlement rules into play.

Even then there is only a charge on the shareholder waiving his rights where the beneficiary of the bounteous arrangement is his spouse or minor child (as S.624 and S.629 ITTOIA 2005 only work to attribute income of settlements for the benefit of spouses and minor children back to the settlor). Dividend waivers made in favour of other family members - for example adult children - would be tax effective (although where dividend waivers are used as part of a wider arrangement to replace employment income, an attack under employment-related securities legislation or disguised remuneration rules might be forthcoming).

In *Buck v HMRC* (2009) Mr Buck owned 9,999 of the 10,000 issued shares in his company. His wife owned one share. Mr Buck waived his right to a dividend and the company duly declared a dividend of £35,000 per share, all of which was paid to his wife in respect of her single share. The company had sufficient distributable reserves to make the dividend payments.

This arrangement was found to be bounteous by the Special Commissions because the company would have needed about £350 million of retained profits to pay a £35,000 per-share dividend had Mr Buck’s waiver not been in place. [The actual distributable profits were around £46,000.] This arrangement would clearly have not been entered into between Mr Buck and an unconnected third party. The dividend waiver is therefore a bounteous arrangement to increase the dividend paid to Mrs Buck and is a settlement of income by Mr Buck to his spouse. The dividend paid to Mrs Buck (i.e., the £35,000) was therefore taxable on Mr Buck under S.624 ITTOIA.

The requirement to retain sufficient profit to cover the waived dividend is both an in-year and a cumulative requirement. This means that before entering into a dividend waiver, we should look back at cumulative retained profits over more than just the current financial period to see if there is enough money in the pot to have paid the dividend had no waivers been made. If not, the arrangement is bounteous and if the person benefiting from the arrangement is a spouse (or minor child) of the shareholder waiving the dividend, the benefit is bounced-back and taxed on the deemed settlor. This is illustrated below.

Illustration

A husband (H) and wife (W) each own 50 shares out of the issued share capital of 100 £1 shares. Retained reserves are minimal.

Year to 31 March 2017

- Profit £85,000.
- H waives his right to the final dividend of £800 per share.
- W receives a dividend of $50 \times £800 = £40,000$.
- Retained profits are $£(85,000 - 40,000) = £45,000$.
- This would be enough to cover the dividend of £40,000 which would have been payable to H had he not waived his right.
- The arrangement is not therefore bounteous as W has not received an increased dividend because of the actions of H.
- The settlements legislation does not apply and W is taxed on a dividend of £50,000.

Year to 31 March 2018:

- Profit £90,000 plus opening reserves of £45,000 = £135,000.
- H waives his right to the final dividend of £1,000 per share.
- W receives a dividend of $50 \times £1,000 = £50,000$.
- Retained profits are $£(135,000 - 50,000) = £85,000$.
- Is this now enough to cover the dividends which would have been payable to H had he not waived his right?
- These would be $£(40,000 + 50,000) = £90,000$. Therefore, no.
- There is therefore bounty here as W has received £5,000 more than she would otherwise have been able to had H not waived his rights.
- The settlements legislation therefore applies and £5,000 of the £50,000 dividend is taxed on H.

But waivers DO work!

Don't let all this lead you to the conclusion that waivers are not effective in tax planning.

If the waiver is commercially justifiable, properly and legally documented, put in place in advance of the dividends being declared and not excessive when measured against retained profits, then HMRC should not have a problem.

Repetitive waivers should be avoided where possible. Therefore if this is a tax planning arrangement that the client wishes to optimise and repeat, having different classes of shares in place for different shareholders is probably a more effective solution. We will cover this in another session.

Contributed by Steve Sanders

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.

Contributed by Steve Sanders