

Meaning of 'ordinary share capital'

(Lecture P1119 – 16.36 minutes)

On 19 September 2018, the CIOT published – with permission – minutes of an HMRC meeting on CGT that took place some months ago attended by representatives of all the main professional bodies. One of the matters discussed was the meaning of the words 'ordinary share capital' in the context of tax legislation.

The term 'ordinary share capital' is defined in S989 ITA 2007 as follows:

'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'.

This definition, despite being found in ITA 2007, applies for CGT matters such as entrepreneurs' relief as well as for income tax. There is an identical definition for corporation tax purposes in S1119 CTA 2010.

Following the decision of the First-Tier Tribunal in *McQuillan v HMRC* (2016), where it was held that a class of redeemable ordinary shares with no dividend entitlement constituted shares which have a right to a dividend at a fixed rate (i.e. 0%) and therefore did not form part of the ordinary share capital of the company concerned, there was widespread uncertainty as to the precise meaning of the term. This was particularly problematic, given that the First-Tier Tribunal's ruling went against HMRC's long-established understanding that, earlier in the same year, had been approved in the case of *Castledine v HMRC* (2016).

In the event, following an appeal, the Upper Tribunal judges overturned the previous decision (see *HMRC v McQuillan* (2017)). The Upper Tribunal did not consider that there was any ambiguity or difficulty about the interpretation of S989 ITA 2007. That legislation, in the judges' opinion, did not countenance a right to no dividend as being a right to a dividend at a fixed rate. They stated:

'It is in our plain view, on the literal meaning of S989 ITA 2007, that to be within (the) excluded class the shares in question must have a right to a dividend. Once it is determined, as a matter of fact, that the shares carried no right to a dividend, there is no question of the shares falling outside the definition of "ordinary share capital".'

The published examples, which were considered at that HMRC meeting, can be found in the 'Technical News' section of the CIOT's website (www.tax.org.uk). The heading for the various examples is 'Preference shares – when are they ordinary share capital?' The details of the more relevant ones are set out below:

Description of situation (+ HMRC's official view)

- Shares with no dividend rights: These count as ordinary share capital – the statutory definition is silent on the question of rights, other than a fixed rate of return.
- Fixed rate preference shares with a zero coupon: These count as ordinary share capital, given that a right to nothing is not a right to something and so these are not shares which entitle the holder to a return at a fixed rate.
- Fixed rate preference shares with a coupon of 0.000001%: These do not count as ordinary share capital – although negligible, it is hard to argue that the coupon is not a fixed rate (however, in avoidance cases, one might expect the Courts to look at the reality and decide otherwise).
- Shares with a fixed rate of 10% cumulative: These do not count as ordinary share capital – the holder knows that the return is fixed even when profits are not available (and so the investment looks more like debt than equity).
- Shares with a fixed rate of 10% non-cumulative: These count as ordinary share capital, given that, in some years, no dividend will be paid and so there is no fixed rate – the return is dependent on the results of the business and consequently the investment looks more like equity than debt.
- Preference shares with a right to 'tiered' dividends: These count as ordinary share capital – although the terms are fixed, the rate is not and so HMRC regard this as representing a non-fixed rate of return.
- Shares which have a right to the greater of a specified sum or the dividend paid in respect of another class of shares: These count as ordinary share capital, given that there is no fixed rate – this type of condition will usually be dependent on the results of the business, again pointing to equity rather than debt.
- Fixed rate preference shares where the holders receive a special payment above the par issue price based on the figure for reserves in the event of the shares being redeemed (or the company being sold or put into liquidation): These count as ordinary share capital – the holder is entitled to a fixed rate of return, but the payment above par represents an 'other right to share in the company's profits' which brings the shares back into the category of ordinary share capital.
- Preference shares with two alternative fixed rates, where the rate used depends on certain events during the year (e.g. the level of the company's profits): These count as ordinary share capital – there is no fixed rate but rather a rate fluctuating between two alternatives which vary according to business results (this again looks more like equity than debt).
- Preference shares where a rate of interest is added if the dividend is unpaid: The cautious view is that these count as ordinary share capital, but, provided that the rate is fixed and cumulative, it should not be so regarded (the additional amount payable in respect of the unpaid dividend represents interest on the sum outstanding rather than a return on the original equity investment).

Although these examples were published with specific reference to entrepreneurs' relief, the definition of 'ordinary share capital' is of relevance in numerous places in the tax legislation and so the illustrations are likely to be useful in helping to understand HMRC's views with regard to many different kinds of preference share capital.

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