Timing of dividends for income tax purposes

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The income tax provisions on the taxation of dividends of UK resident companies are a model example of the interaction between corporate law and tax law. Dividends of UK resident companies are subject to income tax in the hands of shareholders for the period in which payment of the dividend becomes enforceable. Whilst the High Court judgment in *Potel* sets out the general principles determining the point at which each form of dividend becomes due and payable, two recent tribunal decisions provide a helpful summary of the key issues arising where payment of dividends is deferred vis-à-vis other shareholders of the company. In Gould, the FTT held that an enforceable debt did not arise in respect of an interim dividend in respect of which payment to one shareholder was deferred to a subsequent tax year, rejecting a number of corporate law arguments made by HMRC. In *Jays*, the FTT held that excess dividends credited to a blocked account had not been 'paid' for the purposes of the income tax rules. Both cases are a reminder of the extent to which taxation outcomes can depend on other areas of law (in these instances, corporate law) and demonstrate that HMRC will not be limited to 'pure' tax law arguments on appeal.

Introduction

Discussions on the taxation of corporate transactions or actions often focus on the extent to which the interpretation of tax law needs to take account of the economics or the accounting treatment of the steps involved. However, it is important that taxpayers and their advisers remember that the tax treatment is also a function of corporate law, and that corporate law may govern the tax consequences of a given transaction.

The recent decisions of *Gould v HMRC* [2022] UKFTT 431 (TC) and *M Jays and another v HMRC* [2022] UKFTT 420 (TC) show that for income tax purposes, the question of whether and when a dividend has been paid will, in large part, turn on a corporate law analysis of the underlying documentation. Notwithstanding that the appellants in each case were successful, the decisions highlight the need to ensure that documentation of dividends and the underlying constitutional documentation is clear and certain to avoid the risk of challenge.

Both these cases involved family-controlled companies, but these issues could also be relevant for more widely-held companies. The non-tax decision in *Manolete Partners plc v Rutter* [2022] EWHC 2552 (Ch) also demonstrates that making it clear when a dividend is paid may be helpful in the context of a company later getting into financial difficulties and a challenge to the lawfulness of that dividend.

Timing

Dividends of UK resident companies are subject to income tax in the hands of shareholders for the period in which payment of the dividend becomes enforceable. That is the effect of ITTOIA 2005 ss 383(1) and 384(1) read together with CTA 2010 s 1168(1), which deems dividends to be treated as paid on the date when they become 'due and payable.'

The decision in *Potel* provides the clearest summary of the general principles determining the point at which each form of dividend becomes due and payable.

It is necessary to distinguish between two types of dividends. The model articles for both public and private companies provide that the directors have the power to pay an interim dividend, and that the company may by ordinary resolution declare a final dividend. The decision in *Potel v IRC* (1970) 46 TC 658, HC, provides the clearest summary of the general principles determining the point at which each form of dividend becomes due and payable, which can be summarised as follows:

1. resolution by the directors to pay an interim dividend does not create an enforceable debt, because the directors may revoke a decision to pay an interim dividend prior to the date of payment;
2. it follows that an interim dividend does not become due and payable prior to payment thereof;
3. the declaration of a final dividend without any stipulation as to the timing of payment creates an immediately enforceable debt as against the company; and
4. where a final dividend is declared with a stipulation as to the date of payment, no enforceable debt is created until that date arrives.

These principles have generally given limited cause for concern from a tax perspective. Dividends would ordinarily be paid to all shareholders falling within a particular class at the same time, with the date of payment set at a specific date, or would not be paid at all. However, *Gould* and *Jays* provide interesting factual matrices to frame the discussion of the applicability of the *Potel* principles where not all shareholders receive interim dividends at the same time, and where final dividends are declared but there is a provision governing the date of payment of the dividend.

As the starting point for determining when a dividend becomes due and payable is corporate law, it follows that a corporate law analysis of the arrangements is required to determine how far the principles extend. The First-tier Tribunal (FTT), throughout both *Gould* and *Jays*, focused on an analysis of the underlying constitutional documents and corporate authorities to determine whether enforceable rights have been created, to find when a dividend has become due and payable.

Enforceability of interim dividends

In *Gould*, Mr Peter Gould (PG) and Mr Nicholas Gould (NG) were, at the relevant time, directors of Regis Group (Holdings) Ltd (Regis). The entire issued share capital of Regis was held by PG, NG, and the trustees of the Frank Gould 1998 No. 1 Settlement (a settlement under which PG and NG were joint life tenants). PG and NG, as directors of Regis, wished to declare an interim dividend. NG received payment of the interim dividend in one tax year; PG received payment of his dividend the following tax year, in which PG was non-UK resident for income tax purposes. HMRC issued closure notices to PG, asserting that he should be treated as having received the interim dividend at the time it was paid to NG.

Ultimately, it may be unwise to rely solely on the Gould decision to assert that an enforceable debt could never arise in respect of an interim dividend.

HMRC disagreed with an unqualified application of the proposition (from *Potel*) that no rights to an interim dividend are conferred until payment is actually made. HMRC instead argued that PG's interim dividend became due prior to payment, as the payment of an interim dividend to NG created a debt enforceable against Regis by PG, at the time NG was paid. The basis for HMRC's argument was that the articles of association (either on their own terms or read together with general case law principles of shareholder equality) formed a contract under which PG possessed a right, at the point NG received his interim dividend, to enforce a debt against Regis and/or, PG would have been able to obtain an order for payment under a petition for unfair prejudice, creating an enforceable debt, so that the interim dividend had become due and payable for corporate law purposes and therefore taxable.

The articles form part of a company's constitution, the provisions of which 'bind the company and its members to the same extent as if there were covenants on the part of the company and of each member to observe those provisions' (see Companies Act 2006 s 33(1)). However, the courts and tribunals are generally reluctant to assert that a provision in the articles has conferred an enforceable, personal right upon a member qua member. Even where such rights do arise, the case law governing the remedies available to members enforcing the articles is inconsistent and it is difficult to discern any clearly applicable principles for any given claim. It is therefore not surprising that the tribunal in *Gould* were hesitant to anticipate the remedy in a hypothetical claim for enforcement by PG, and that the tribunal declined to find that an enforceable debt would necessarily be created as a result of a successful claim (whether such claim existed or not).

Because of difficulties in enforcing the articles, shareholders may instead seek relief on the grounds of unfair prejudice under s 994 of the Companies Act 2006. Indeed, HMRC suggested PG would have been able to do so, creating an enforceable debt at the time it became available to PG to make such a petition. Again, the tribunal refused to anticipate how a court would use its discretion to determine a remedy for any such petition (if it could be made) and declined to find that enforcement of a legal debt would be ordered as a result. Interestingly, the tribunal questioned – but did not comment on – whether an order to enforce the interim payment as a legal debt would set or move the tax point to the time of NG's receipt (rather than the time such an order would be made). However, it was found unnecessary to make such a finding.

The tribunal's approach in focusing on the diversity of remedies available and declining to decide the remedy for a hypothetical claim appears sensible. Given that the question is whether an enforceable debt has arisen in respect of an interim dividend, and absent any clear statement in the articles that such an enforceable debt had been created or the matter being put beyond doubt by the dividend being declared by shareholders, it would appear difficult to surmount the hurdle that judicial discretion provided in this case. HMRC would have had to have shown that an enforceable debt had arisen by inferring principles from hypothetical corporate law actions PG might have taken and arriving at a wide variety of discretionary remedies. The tribunal took considerable comfort from the facts in this case; PG was an experienced businessman and accepted that he was taking a risk in deciding not to take the dividend until six months later, but was comfortable that the directors would be unlikely to fail to make payment of the dividend.

Ultimately, it may be unwise to rely solely on the *Gould* decision to assert that an enforceable debt could never arise in respect of an interim dividend. A more 'activist' tribunal may have felt inclined to decide the hypothetical claims in support of HMRC's conclusion, faced with different facts; it would be advisable for taxpayers in a similar position to consider carefully whether enforceable personal rights have arisen, either under the constitutional nexus of the issuing company or any shareholders' agreement (or similar arrangements). HMRC appears more than willing to fully engage with the corporate law angle, and while the decision may not provide a reliable precedent for taxpayers, it does indicate that there may be future HMRC challenges in this area.

The tribunal left open the possibility that PG had waived his entitlement to the interim dividend and the possibility that PG and NG (in their capacity as shareholders) had amended the articles by virtue of the *Duomatic* principle which allows informal unanimous shareholder approval of company actions in some circumstances. While on the facts of this case it may not have been necessary, it may be preferable for a formal deed of waiver to be executed by the relevant shareholder in respect of the dividend or for the minutes of the directors' meeting (or written resolutions, as applicable) to make it clear how and when each dividend will be paid.

Accordingly, it is generally preferable that shareholders sensitive to timing consider whether, in respect of interim dividends, the articles of the issuing company confer enforceable personal rights on them qua member, or whether some other arrangement (for example, a shareholders' resolution) could do so prior to receiving payment. If there is any concern, (while this may be not in fact needed), it could be mitigated by dealing expressly with the issue at the time.

Has a final dividend been paid

Jays perhaps shows that the courts and tribunals remain reluctant to assert that income not received is taxable, and that they will take a pragmatic view of when the declaration of a final dividend creates an enforceable debt. However, where a timing stipulation is contingent upon future events rather than payable on a fixed date, there is limited guidance as to when that contingency creates an enforceable debt.

At the relevant time, Mr and Mrs Jays (the appellants) were, respectively, the sole director and company secretary of Questor Properties Ltd (QPL), and held the sole issued share in QPL jointly. Due to arrangements entered into with a financial services provider, dividends declared by QPL in excess of a cap were credited to a blocked account, inaccessible to the appellants. Mr Jays wished to attract equity investment into QPL and believed that declaring dividends in excess of the cap would demonstrate its financial strength. QPL declared what the tribunal determined were final dividends in excess of the cap and these 'excess dividends' were credited to the blocked account, pending removal of the inaccessibility arrangements. Mr and Mrs Jays did not declare the excess dividends on self-assessment, and HMRC issued discovery and penalty assessments in respect of income tax said to be chargeable on the excess dividends.

The extent to which each case provides comfort (rather than a checklist of concerns) is unclear, and *Jays* in particular leaves some key questions outstanding with respect to the interaction between receipt and deferral in the context of contingent final dividends.

Ultimately, the FTT in Jays tasked itself with determining whether the excess dividends were, by virtue of the credit to the blocked account, 'paid' for the purposes of ITTOIA 2005 s 384(1). The tribunal's analysis in this regard centred on whether the declarations of the excess dividends were subject to a payment date stipulation, such that no immediately enforceable debt was created.

As the minutes declaring each excess dividend referenced the deferral of each relevant appellant's actual entitlement, the tribunal held that no enforceable debt was created on declaration (and presumably, that would be the case for as long as the inaccessibility arrangements subsisted). Two questions arise in this regard: how did the transactions entered into amount to a timing stipulation and, if crediting the blocked account is more than a mere accounting entry, does the credit to the account 'settle' the timing stipulation?

In reaching its decision, the tribunal did not analyse the legal and beneficial entitlements to the blocked funds but rather looked at the terms of the minutes. The argument seems to be that because the minutes imposed a fetter on the ability of the shareholder to deal with the funds, as opposed to them being paid to the shareholder and the shareholder (then) agreeing not to access them, the shareholder would not have been able to enforce the payment obligation unless and until the due date for payment (which depended upon either agreement or notice). As such, the arrangements could be distinguished from a situation where a shareholder deposits funds as security for a guarantee.

Again, this case very much turned on its specific facts and it will be interesting to see how, if appealed, the Upper Tribunal would look at the same facts. What is not clear is how the dividends were treated in the accounts of the paying company; if the distributable reserves were debited when the payments were made to the blocked account, there may be a mismatch between the date of payment for accounting purposes and the date of receipt for tax purposes.

Shareholders of owner-managed and other closely held companies would do well to consider the ramifications of entering into (quasi) security arrangements in respect of dividend payments. The limited guidance offered by *Jays* and other case law may make it difficult to conduct a detailed analysis to achieve a higher degree of certainty.

What is, however, clear is that much hinges on how the arrangements are documented and the analysis from a corporate law perspective.

Conclusion

Across *Gould* and *Jays*, shareholders are provided with a helpful summary of the key issues arising where payment of dividends is deferred vis-à-vis other shareholders or the company. However, the extent to which each provides comfort (rather than a checklist of concerns) is unclear, and *Jays* in particular leaves some key questions outstanding with respect to the interaction between receipt and deferral in the context of contingent final dividends.

In most cases, and to the extent possible, taxpayers would do well to ensure that dividends fall within a clear and certain application of the principles outlined in *Potel*. Where that is not possible, *Gould* and *Jays* provide, at the very least, some helpful points to consider where timing issues present themselves, and a reminder of the pertinence of corporate law in determining the tax treatment of transactions.

Contacts

Dominic Stuttaford
Global Head of Tax
Tel +44 20 7444 3379
dominic.stuttaford@nortonrosefulbright.com

Aiden Hepworth
Associate
Tel +44 20 7444 3793
aiden.hepworth@nortonrosefulbright.com

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