TAX SAVING THROUGH (STOCK) DIVIDENDS

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The purpose of this short article is to discuss two ways of saving tax by the use of dividends.

The First Way

The first is to do with income tax. It assumes that a shareholder is liable to income tax at the higher rate but his wife has no, or little, income of her own so that her basic rate income tax band is "wasted". If the shareholder gave his wife some of his shares she could receive a dividend up to the limit of the basic rate limit, and thus save higher rate tax. But he may not be willing to give her any of his shares, at least not by way of outright gift. Perhaps a special class of non-voting shares could be created and he could give them to his wife but the gift would be a "settlement", and so ineffective to save income tax, if the shares are, as they may well be, "wholly or substantially" a right to income: see s.685(4A) Taxes Act 1988. A much simpler alternative to a gift of shares is for the shareholder to transfer some or all of his shares into the joint names of himself and his wife, on terms that they are to hold the shares as trustees on trust for him alone absolutely. Dividends declared on shares in their joint names will be treated for income tax purposes as "income to which they are beneficially entitled in equal shares": see s.282A(1) Taxes Act 1988. The fact that the wife actually has no beneficial interest at all is irrelevant unless a declaration is made under s.282A(3), but no such declaration need be made. The settlement provisions cannot apply to the transfer into joint names because there is no element of bounty and so no "settlement": see *IRC v Plummer* 54 TC 1.

The Second Way

The second is to do with capital gains tax. It assumes that the shareholder is

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thinking of selling his shares, and that a chargeable gain would arise on the sale which would be subject to capital gains tax at 40%. In a recent article in this Review (1 PTPR 3 (1991/92) 177) I discussed a way of reducing the rate of charge to 25%. Here I discuss another way to reduce the rate of charge to 25% by a stock dividend.

A "stock dividend" is (or includes) a bonus issue of new shares received by the shareholder in exercise of an option to take either shares or a cash dividend: see s.249(1)(a) Taxes Act 1988. The bonus shares are deemed to be income of the shareholder for income tax purposes: s.249(4). The amount of the deemed income is "the appropriate amount in cash" as defined (broadly, the market value of the bonus shares) grossed-up at the rate of 20% (after 6th April 1993). That amount is liable to income tax with a credit for tax at the 20% rate. Thus the effective rate of charge is 25% of the "appropriate amount in cash", just like a cash dividend of that amount. However, there are two fundamental differences between a cash dividend and a stock dividend. First, when the company pays a cash dividend, it must pay advance corporation tax to the Revenue, because the dividend is a "distribution"; but a stock dividend is not deemed to be a distribution and so no ACT is payable. Secondly, for capital gains tax purposes, the issue of the bonus shares is a "reorganisation" of the company's share capital but the shareholder's acquisition cost of his shares is deemed to be increased by the "appropriate amount in cash": see s.141 Taxation of the Chargeable Gains Act 1992. Thus when the shares are sold the chargeable gain, and so the amount taxable at 40%, is reduced by the "appropriate amount in cash", at the cost of an income tax charge on that amount at just 25%. The tax bill on the "appropriate amount" is reduced by 37.5%.

Let us take an example. X owns all the shares in a company. The shares are worth £1 million. He has a nil base cost for his shares for CGT purposes. Thus the CGT payable on a sale would be £400,000. The company grants him an option to choose between a cash dividend and bonus shares. The bonus shares will be of such a number, and/or will carry such rights, as to "swamp" the existing share capital and so be worth £1 million. X chooses the bonus shares. He will have to pay income tax of £250,000. But when he sells his shares for £1 million he will pay no capital gains tax.

This example highlights the following point: the bonus shares can be worth £1 million on account of the rights they carry, even though the nominal value of the bonus shares may be very small. Thus the company does not need to have £1 million of distributable reserves in order to be able to issue bonus shares worth £1 million. Indeed, the company could offer X a cash dividend of £100 or bonus shares with a nominal value of £100 but having an actual value of £1 million.

Can the Revenue prevent tax being saved by the use of a stock dividend? Section 703 Taxes Act 1988 is not in point because the shareholder has not obtained a "tax advantage" as defined: on the contrary he has turned capital into income. The company is not a "person in question" within s.704 and so it cannot be attacked either. What about the "new approach"? Clearly this would apply if a sale of the shares is pre-ordained at the time when the company grants the option. It could perhaps apply if a sale is pre-ordained by the time the shareholder exercises his option to take bonus shares. To be safe, the option must be granted *and* exercised before a sale is "cut and dried". This may present a practical problem: is the shareholder willing to take bonus shares, and a 25% income tax liability, and yet run the risk of not selling his shares shortly thereafter or at all? Moreover, there may be a valuation problem: if there is no pre-ordained sale when the bonus shares fall to be issued, the "appropriate amount in cash", being the market value of the bonus shares at that time, may be substantially less than the eventual sale proceeds, so that the excess proceeds will represent a chargeable gain taxable at 40%. It may be that these problems can be overcome by the use of an option, or even cross-options (although the latter are more vulnerable to the "new approach").

Is it possible to reduce the rate of charge to less than 25%? The following should be considered. The shareholder settles his shares upon trusts under which he has an interest in all but a small percentage of the trust fund, that part being held on discretionary trusts from which he (and his wife) are totally excluded. It is assumed that full hold-over relief from capital gains tax can be claimed in respect of the disposal of his shares to the trustees of the settlement. The company then grants the trustees the option to take a cash dividend or bonus shares; the trustees opt for bonus shares. What is the analysis then? Section 249(6) Taxes Act 1988 provides that if the case is one in which a dividend in cash paid to the trustees in respect of their shares "would have been to any extent income to which s.686 [additional rate] applies", then income of the "appropriate amount in cash" is treated as having arisen to the trustees. That deemed income is then liable to income tax at 15% of the grossed-up amount of the value of the bonus shares, giving an effective rate of 18.75%. The capital gains tax "uplift" under s.141 TCGA 1992 still applies, reducing the rate of charge from 40% to 18.75%. This seems too good to be true; surely, it will be said, the income tax settlement provisions apply to treat the deemed s.249(6) income as (nearly all) income of the settlor? Arguably not, for although income is treated as having arisen to the trustees, the bonus shares are not deemed to be that income; the deemed income is purely notional. It is arguable, therefore, that the deemed income is not "income arising under the settlement", or (if it is) is not income which is payable to or applicable for the benefit of the settlor or any other person, and so is not caught by any of ss.660-683 Taxes Act 1988.