The Personal Tax Planning Review

INDIRECT DEMERGERS - TRUST CAPITAL OR INCOME?

Robert Venables QC[1]

The rules for determining whether for trust purposes a receipt by trustees is income or capital, and is therefore payable to the tenant for life,[2] or is to be added to the capital of the trust fund is determined purely by principles of trust law which are quite independent of those of income tax law. One of the greatest areas of difficulty is where the trustees receive a distribution in respect of shares in a company. The distribution may consist of cash or of shares in the same or another company. The position becomes even more complicated where the trustees have an option either to take cash or to take shares and becomes even more complicated still where the option to take shares is more valuable, from the point of view of the trust as a whole, than that to take cash.

These questions have become acutely relevant recently. There is much case law, little of it known to tax practitioners. I am at present undertaking an exhaustive review of the authorities and hope in due course, professional commitments permitting, to publish a more extensive survey. In the meantime, I am writing this Note on *Lee deceased, Sinclair v Lee* decided by the Vice-Chancellor on 30th April 1993.[3]

One thing is clear. The state of the law is thoroughly unsatisfactory. Learned counsel have been deeply divided between two schools. Firstly, there are the traditionalists, who are by far the more numerous, who have sought to apply with full rigor the traditional rules, as they understand them, even in situations where this leads to the most nonsensical results. Secondly, there are the less timorous

---

1 Robert Venables QC, 24 Old Buildings, Lincoln's Inn, London WC2A 3UJ
Tel (071) 242 2744 Fax: (071) 831 8095

Consulting Editor of this *Review* and author of numerous publications recently including *Non-Resident Trusts* Fifth Edition published by Key Haven Publications PLC June 1993.

2 I use this term to include any beneficiary entitled to an interest in possession.

3 So far, a note of this decision appeared in [1991] STI 844. I have had the advantage of seeing a transcript of the judgment. No doubt it will be reported in due course in [1993] STC.

souls, including myself and, it now appears, the Vice-Chancellor, who consider that the courts in 1993 are likely to overrule, distinguish or "interpret" the older authorities and apply a "substance" rather than a formal test.

After several twists and turns during the course of the 19th century, the law was "settled" by the decision of the House of Lords in *Bouch v Sproule* 12 App Cas 385, where it was decided that anything distributed out of the assets of a company to its members other than a repayment of capital is income for trust purposes and therefore belongs to the tenant for life. To this rule there has always been one, illogical, yet agreed exception, namely that it does not apply to a return of undistributed profits on *liquidation*.

The rule has the advantage of apparent certainty. Yet unless it is qualified further, it can lead to injustice and even absurdity in several situations.

For Schedule F income tax purposes, in ascertaining whether a payment made to a shareholder by a company in respect of shares constitutes taxable income, one, broadly speaking, asks what the shareholder (or his predecessors in title) put into the company and treats anything else which comes back to him as being income (unless the repayment occurs on liquidation). That, at least, is a logical rule. The trust rule,[4] however, is far less logical. It was settled at the very latest in *Bouch v Sproule* that where a company capitalises profits available for distribution, then, if those profits are subsequently distributed, they will represent capital and not income in the hands of the shareholder trustees. The most obvious means by which profits can be capitalised is by the issue of bonus shares credited as fully paid up. Now if that were all which were done, one must inevitably hold that there has been no income distribution. For the company has not in fact distributed anything at all. Whereas, say, previously a shareholder had 100 £1 shares he might now have 1,000 10p shares. The reality is that nothing very much has happened. The interesting point is when the bonus share capital is repaid. At that point, one forgets that it was paid up with what were historically distributable profits and now treats the repayment in the same way as repayment of capital paid up on any other shares, just as if the shareholders or their predecessors in title had subscribed their own capital and added funds to the company in consideration of the issue of shares in the first place. Thus, one way of avoiding income tax was for a company to capitalise its profits by a bonus issue and then in due course to repay the bonus issue. What the shareholders received was non-taxable capital. See the House of Lords decision in *IRC v Blott* (1921) 8 TC 101.

---

[4] The trust rule is a rule of case law. It applies not only to trusts but in determining, in the absence of any statutory definitions, whether a payment constitutes capital or income. The two House of Lords cases next cited were in fact tax cases where the shareholders were not trustees. Their actual effect has, of course, been reversed by the modern Schedule F legislation.

The House of Lords went even further in *IRC v Fisher's Executors* (1926) 10 TC 302 in holding that profits could also be capitalised by the issue of what one might term bonus debentures, i.e., debentures credited as fully paid up by the utilisation of profits of the company available for distribution. The House of Lords could easily have held that the case was distinguishable from *Blott*. In *Blott*, the rights of the shareholders were in substance unchanged. The holder of ten shares of 10p each was in exactly the same position as the holder of 1 share of £1. In the case of bonus debentures, however, the shareholder becomes a creditor of the company and can sue for interest and principal payable under the debentures as and when they fall due. Moreover, something has come out of the company in a very real way, in that the net assets of the company have been reduced. The position is in every way analogous to that where a company declares a dividend and for some reason that dividend has not yet been paid. So their Lordships *could* have distinguished *Blott*. *"Dis aliter visum."*

Now it will be readily apprehended that the reasons which might motivate a company to capitalise its profits will usually have nothing to do with the question as to whether it is just that a distribution from the company should belong to the tenant for life or to the remainderman or should be some how apportioned between the two. The considerations which the company in general meeting will consider may be commercial or fiscal or may involve considerations of company law or even accounting standards.

Another unsatisfactory feature of the rule is that it apparently applies to a division of capital profits of the company as much as income profits.[5] If the trustees were partners, whether active, sleeping or limited, in a partnership which realised both income and capital profits, then there would be no doubt but that capital profits of the partnership would be capital profits of the trust as and when realised and their payment over to the trustees while the partnership was a going concern would not convert them into income. Yet as soon as the trustees become shareholders in a corporation, which has a distinct legal personality, everything which comes out of the company on a going concern basis is transmogrified into income. Whatever the reasons for carrying on business through a corporation rather than a partnership may be, the last factor in anybody's mind will be an intention to make capital profits available for distribution to income beneficiaries.

Where trustees have subscribed for shares, then, at least in non-inflationary times, it seems not unjust that, as and when profits of the company are distributed, they

[5] The most striking example of this, if it was correctly decided, is *Hill*, discussed below.

should be considered as income.[6] For the capital of the trust has not been diminished. If the entire income of the company had been paid out year by year, there would have been no question. (There is also the possibility that capital might have been lost in earlier years and dividends paid out of profits of subsequent years before the lost capital had been made good. This is a much more debatable question. In the case of a modern English company, the question cannot normally arise because of the statutory restrictions to distributions out of distributable profits only.) Yet if the trustees purchase shares for a price greater than the amount of capital paid up, or credited as paid up, on them, a distribution out of what one might term pre-acquisition profits would in reality be a return of trust capital invested. One would at least expect a qualification to the main rule in such a case yet in English law, at any rate, one may at present look in vain.

One of the difficulties with leading cases which lay down judge-made law rules of potentially wide application is that everyone remembers the short encapsulation of the principle decided, which is to be found in all the text books, but few indeed actually read the case in depth to discover the detailed reasoning. The detailed reasoning is essential if one is seeking to apply the principles laid down by the case to a slightly different factual situation. Sometimes, it may be quite evident from reading the case in full that their Lordships would not have applied the principle without qualification in the new factual situation. If one simply takes the principle out of the textbook and applies it mechanically, one may well fall into error. And this is quite understandable. A Revenue Silk has the luxury of being paid to go beyond the textbooks and back to the primary sources. Yet that is a luxury which few can afford. *Bouch v Sproule* is an excellent example of a case which repays close reading.

What has been consistently overlooked or ignored by the "traditional" camp is that in *Bouch v Sproule* itself the House of Lords introduced an important qualification to the rule based on a substance test. In that case, the company declared a dividend which the shareholders were free to take in cash and at the same time offered a rights issue, the amount the shareholders were invited to pay for their new shares being equal to the amount of the cash dividend. The trustees in question took up their rights, as any shareholder would have done to prevent his interest being diluted, and used the cash dividend to do so.

It was quite clear that technically the dividend was of an income nature. The trustees had literally used income to acquire new shares.[7] Now it was obviously

6 Of course, this does not answer the objection that distributed capital profits of the company are also treated as income.

7 Hence, the case of the modern stock option is distinguishable. I hope to return to this in a later article.

the duty of the trustees to take up the rights issue if they possibly could; otherwise, the value of the trust's holding would have been diluted to the benefit of the other shareholders. What they were not entitled to, however, was to use the tenant for life's money to do so. The tenant for life was therefore entitled to be repaid that money, plus equitable "interest" to compensate for any delay and would arguably have had a security interest in the newly issued shares until payment.

That would have been the result of a strict application of the principle cited in all the textbooks. Yet the House of Lords held that as no one in their right mind would have failed to take up the rights issue, it was a foregone conclusion that the dividend would finish up back in the company and therefore this was *in substance* equivalent to an issue of bonus shares credited as fully paid up.

Hence we have the most extraordinary situation that the highest authority, which apparently lays down a very formal test, is prepared immediately to abandon that test and to apply a substance test! If only this had been acutely perceived by later judges and counsel, especially in *Hill v Permanent Trustee Company New South Wales Limited* [1930] AC 720, where the Privy Council applied the basic rule in *Bouch v Sproule* without qualification so as to produce the most ridiculous result! A company decided to stop farming and to sell off its lands, at a hugh capital profit. Normally, the company would have gone directly into liquidation, in which case everything received by the trustee shareholders would have constituted capital, as in reality it was. As the sale of the company's property took some time, it continued in existence for some years, selling off properties and *in the meantime distributing profits by way of dividend.* It was held, subject to one vital argument reserved to those interested in capital,[8] that the distributions represented trust capital.

Lee Deceased concerned the proposed ICI demerger which was to be an "indirect" demerger (i.e., one potentially within TA 1988 s.213(3)(b)) under which ICI declares and pays a dividend in specie of shares in a subsidiary company (Zeneca Ltd) which is paid not directly to the shareholders (as in the case of a direct demerger potentially falling within under s.213(3)(a)) but to a newly created company (Zeneca Group PLC) which in turn issues shares to shareholders.

The trustees held shares in ICI upon trust for the testatrix's husband for life, remainder to her son absolutely. It appears that the trustees had a power of sale over the shares.

---

[8] on which they succeeded in later proceedings.

Before the Demerger

Shareholders

ICI

Zeneca Ltd

****

After the Demerger

Shareholders

ICI *Zeneca Group PLC*

Zeneca Ltd

The Vice-Chancellor found that the shares in Zeneca Group to be received by the trustees would constitute trust *capital*. He considered *Hill* binding upon him by virtue of its approval by the Court of Appeal in *Reed v Doughty* [1947] Ch 263.

The judgment is one of the most refreshing I have seen in years. Instead of setting up the authorities and then slavishly applying them in the blinkered fashion of the Privy Council in *Hill*, the Vice-Chancellor first stated that if one considered the position untrammelled by authority, one would have no hesitation in saying that the shares in Zeneca Group PLC constituted trust capital. He then discussed the rules on their merits and only finally turned to the authorities, which he obviously (and quite correctly) regarded as an obstacle to his arriving at the only sensible and just result, and adroitly distinguished them.

He stated:

> "When the inflexible application of [the principles in *Hill*] would produce a result manifestly inconsistent with the presumed intention of the testator or settlor, the court should not be required to apply them slavishly. In origin they were guidelines. They should not be applied in circumstances, or in a manner, which would defeat the very purpose which they are designed to achieve. Unless constrained by binding authority to the contrary, I consider that ICI's transaction should be characterised as a company reconstruction, with two capital assets (shares in ICI and Zeneca Group) in the trustees' hands replacing one existing capital asset (shares in ICI)."

He distinguished early Court of Appeal authority, in particular *Reed v Thomas* [1916] 2 Ch 331 as being concerned with a *direct* transfer of shares to shareholders. Hence, had this been a direct rather than an indirect demerger, he would have felt constrained by authority! Is there any difference at all in principle? Of course, there is no difference at all in principle. What is clear is that the Vice-Chancellor was concerned firstly to do justice in the individual case and secondly further to erode the principle in *Hill* as much as possible with a view to its being ultimately overruled by the House of Lords.

To my mind, this is the beginning of the end of *Hill*. Yet its demise may take a long time. It will be eroded and chipped away at until there is little left of it. There are a sufficient number of cases of company distributions now occurring to warrant the expense of litigation to a sufficiently high level to clarify the law.

In this article, I have concentrated on some of the anomalies and absurdities produced by the strict application of what one might call the textbook ratio of *Bouch v Sproule*. I must admit that it is far easier to criticise the rule than to produce another rule which would work justice in all cases. In my view, the best way forward is to retain the basic rule but to qualify it with a set of sub-rules. While the application of the substance test will produce a just result in extreme cases, such as that in *Lee*, such a test is by its nature too vague to enable one to fine-tune cases nearer to the borderline. My prediction is that over the next few years the courts will lay down further exceptions to the basic rule on a case by case basis so that a much clearer picture gradually appears. I hope in the later article to predict what those changes may be and, possibly, to facilitate them by suggesting a sound technical basis upon which they may be laid. By way of appetizer, I should mention that I consider that there is substantial scope for an extension to the principle, not previously mentioned in this article, that where trustees should not have allowed a windfall profit to accrue to the tenant for life, then such a profit represents trust capital after all.

I end this article with a little teaser. Supposing that an English company purchases its own shares from trustee shareholders. The price paid exceeds the amount of capital paid up (or credited as paid up) on the shares. There is no question of the company going into liquidation. Does such part of the amount paid by the company as is in excess of the capital paid up represent trust capital or income? If one applies the textbook version of the rule in *Bouch v Sproule*, as the Privy Council did in *Hill*, there is no question but that the excess is income. Yet I wonder how many trustees have even paused to ask themselves the question and have not simply assumed that of course the sum received is entirely capital, just as if they had sold the shares to a third party. Is their assumption correct? If so, what is the technical reason?