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PURCHASE OF OWN SHARES BY NON-UK INCORPORATED COMPANIES - CAPITAL OR INCOME?

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An interesting question which I have had cause to consider at various times over the past few years is this: does the purchase of its own shares by a non-UK incorporated company, where the purchase price is at a premium to the amount originally contributed as capital, constitute an income or capital receipt in the hands of an outgoing UK shareholder? The significance of the question is that various small (and not so small) financial services businesses are set up as private non-UK incorporated companies owned by senior executives who are required to sell their shares back to the company on ceasing employment. Given the favourable rates of capital gains tax introduced in Finance Act 1988, and the possibilities for non-UK domiciliaries of avoiding tax altogether on the disposal of non-UK assets, this is often a critical issue.

There are two leading cases on the subject:

(a) In *CIR v Reid's Trustees* (1949) a distribution paid by a South African company out of the capital profits arising from a property sale was held by the House of Lords to constitute an income receipt taxable under Schedule D Case V when received by the trustees of a UK trust.

(b) In *Rae (HM Inspector of Taxes) v Lazard Investment Co Ltd* (1963) a distribution of shares in a newly incorporated company ("A") by an existing company established under the laws of the State of Maryland ("C"), following the transfer of part of C's business to A, was held by the House of Lords to be a capital receipt by Lazard Investment Co Ltd, a shareholder in C.

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In both the *Reid's Trustees* and the *Lazard* cases the judgments in the various courts, including the House of Lords, stressed the importance of the character of the distribution under local law. This is why it is necessary to examine, in some detail, the relevant local company law statutes, and where necessary, to take advice from local attorneys.

Many companies of the type described in the first paragraph are set up in tax havens and other low tax territories, often those (like Bermuda and the Cayman Islands) whose laws were originally based on English law principles. It is these former English law territories which I have primarily focussed on in this article.

The local attorneys' advice often is inconclusive, but can generally be summarised as follows:

(a) it is not necessary to characterise a payment as capital or revenue for domestic purposes so that there is no clear position under local law on this point;

(b) that said, the purchase of own shares out of paid-up capital would appear to be a capital transaction;

(c) the purchase of own shares at a premium (i.e., over and above the amount of capital contributed) is made out of funds which would otherwise be available for the payment of dividends, which might characterise the payment as revenue rather than capital, but there is no reason under domestic law to draw this distinction.

While recognising the point being made in (c) above, and it is certainly true that accounting evidence will be considered by an English Court in determining what is the correct tax treatment, it is not true to say that the fact that a premium on redemption is payable out of reserves which might otherwise be used to pay dividends is critical in determining the character of the receipt in the hands of an outgoing shareholder. I would quote in support of this comments made by Lord Reid in the *Lazard* case:

> "In deciding whether a shareholder receives a distribution as capital or income, our law goes by the form in which the distribution is made rather than by the substance of the transaction. Capital in the hands of the company becomes income in the hands of the shareholders if distributed as a dividend, while accumulated income in the hands of the company becomes capital in the hands of the shareholders if distributed in a liquidation".

One of the key tests applied by the courts in the *Lazard* case is this. As a result of the distribution, what happens to the asset in respect of which the distribution is made? If the asset (the shares) remains intact, as in the *Reid's Trustees* case, then there is a presumption that the distribution must be an income distribution made *in respect of* the asset. If the asset is depleted, as in the *Lazard* case, then there is a presumption that the distribution must be a capital distribution made *out of* the asset.

This test is helpful in the present instance. The asset (the shares) is clearly depleted by the distribution, in the sense that it is removed from the shareholder and subsequently disappears entirely (when the shares are cancelled). On the *Lazard* test this is a strong indication that the distribution is capital.

Although, following *Lazard* and *Reid's Trustees*, it is the position under local law that is critical, given that the origins of local law in the territories we are primarily considering lie in English law, it is worth considering whether a distribution by a UK incorporated company on the purchase of its own shares would be capital or revenue. The analysis is as follows:

(a) Under English tax law any distribution out of the assets of a company (whether in cash or otherwise) is treated as an income distribution unless one of various exceptions applies, including repayments of share capital, certain demergers and certain purchases of own shares by private companies (where special conditions apply). It is this provision that causes the purchase consideration paid by a UK company for its own shares (other than an amount equal to the capital originally contributed) to be taxed as income. However, there is generally no equivalent provision in the local law.

(b) Under English company law it is established that a distribution made on a duly authorised reduction of share capital is capital,[2] as is a distribution of accumulated profits on a winding up.[3] By analogy there is some cause for believing that a payment made on an authorised purchase of own shares is also capital, but there is no clear precedent on the point.

Taking all of these arguments together, one is drawn to the conclusion that there are good reasons for believing that distributions made to shareholders on the purchase of their shares by the company represents a capital receipt and not an income receipt - which is good news for the outgoing shareholders!

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2 *Re Duff's Settlement* [1951] Ch 923.

3 *Stafford Coal and Iron Co Ltd v Brogan* (1963) 41 TC 305.