

STOCK DIVIDENDS RECEIVED BY TRUSTEES

Robert Venables QC¹

1. The Problem

Elsewhere in this issue of this Review, Kevin Prosser QC, Julian Ghosh and I have discussed stock dividends received by higher rate tax payers. In certain cases, trustees who receive a distribution from a company of its own stock of stock are liable to an income tax charge, imposed on an amount which is normally equal to the value of the stock. The charge is imposed by Taxes Act 1988 section 249(6). It has been suggested, by Richard Bramwell QC and his co-authors, in Chapter 11 of the First Cumulative Supplement to the seventh edition of his *Company Taxation* at 11-47B, that when a stock dividend received by trustees is taxable, it is *always* taxable at the Schedule F trust rate, so that, after allowing for the tax credit, the trustees will be liable to pay income tax at a rate of 16.66 % of the value of the stock.

In this article, I respectfully disagree with that conclusion and argue that in some cases the trustees are liable to pay no tax beyond the amount of the credit.

2. Scope of Application of Section 249

Section 249 (Stock dividends treated as income) applies to any of the following share capital:

- “(a) any share capital issued by a company resident in the United Kingdom in consequence of the exercise by any person of an option conferred on him to receive in respect of shares in the company (whether the last-mentioned shares were issued before

¹ Robert Venables QC, Barrister, Benchers of the Middle Temple, Council Member of the Chartered Institute of Taxation, Chartered Tax Advisor, Consulting Editor. Chambers: 24, Old Buildings, Lincoln's Inn, London WC2A 3UP; Tel: + 44 (0)20 7242 2744; Fax: + 44 (0) 20 7831 8095; e-mail taxchambers@compuserve.com

or after the coming into force of this section) either a dividend in cash or additional share capital; and

- (b) any bonus share capital issued by a company so resident in respect of any shares in the company of a relevant class (whether the last-mentioned shares were issued before or after the coming into force of this section)."

The first case is rather more common than the second.

3. The Charges on Stock Dividends Received by Trusts

3.1 Equitable ownership

When a stock dividend is received by trustees, one must first ascertain to whom it belongs in equity. That is a matter of trust law. If it is trust income and there is a beneficiary who is entitled for an interest in possession, then the stock will belong to that beneficiary. If the beneficiary is an individual, he will be liable to income tax in just the same way as if he had been absolutely entitled to the shares which were the tree of which the stock dividend was the fruit.²

3.2 Charge on Trustees

3.2.1 The Statute

If there is no beneficiary who is entitled to the stock dividend as it arises, there will be a charge to income tax on the trustees only if section 249(6) operates. It provides:

"(6) Where a company issues any share capital to trustees in respect of any shares in the company held by them (or by them and one or more other persons) in a case in which a dividend in cash paid to the trustees in respect of those shares would have been to any extent income to which section 686 applies, then-

- (a) there shall be ascertained the amount of income which, if the case had been one in which an individual was beneficially entitled to that share capital, that individual would have been treated under subsection (4) above as having received; and

- (b) income of that amount shall be treated as having arisen to the trustees on the due date of issue and as if it had been chargeable to income tax at the Schedule F ordinary rate; and
- (c) paragraphs (a) to (c) of subsection (4) above shall, with the substitution of “income” for “total income” and with all other necessary modifications, apply to that income as they apply to income which an individual is treated as having received under that subsection.

Section 294(4) provides:

“(4) Subject to the following provisions of this section, where a company issues any share capital in a case in which an individual is beneficially entitled to that share capital, that individual shall be treated as having received on the due date of issue income of an amount which, if reduced by an amount equal to income tax on that income at the Schedule F ordinary rate for the year of assessment in which that date fell, would be equal to the appropriate amount in cash, and-

- (a) the individual shall be treated as having paid income tax at the Schedule F ordinary rate on that income or, if his total income is reduced by any deductions, on so much of it as is part of his total income as so reduced;
- (b) no repayment shall be made of income tax treated by virtue of paragraph (a) above as having been paid; and
- (c) that income shall be treated (without prejudice to paragraph (a) above) as if it were income to which section 1A applies as it applies to income chargeable under Schedule F, but shall be treated for the purposes of sections 348 and 349(1) as not brought into charge to income tax.”

3.2.2 The Precondition

Thus it is a precondition of section 249(6) applying that “a dividend in cash paid to the trustees in respect of the shares [i.e. the shares originally owned] would have been to any extent income to which section 686 applies”. Section 686 applies only to “income arising to trustees in any year of assessment so far as it-

- (a) is income which is to be accumulated or which is payable at the discretion of the trustees or any other person (whether or not the trustees have power to accumulate it); and
- (b) is not, before being distributed, either-
 - (i) the income of any person other than the trustees, or
 - (ii) treated for any of the purposes of the Income Tax Acts as the income of a settlor ...”³

It is partly a question of fact and partly a question of trust law whether a cash dividend would be taxable under section 686. If the trust is not an interest in possession one and if the trust income is not deemed to be the income of the settlor, it normally would be.

In my view, the reference in section 249(6) to section 686 is merely to define the precondition of section 249(6) applying.

3.2.3 The Result of Section 249(6) Applying

Once the precondition is satisfied, an amount of income (usually equal to the value of the stock dividend) is deemed to be that of the trustees for income tax purposes. Yet at what rate is it taxable? Section 249(6)(b) merely states that it is “chargeable to income tax at the Schedule F ordinary rate”, i.e. 10%: section 1B(2)(a). And the trustees are given a credit for that 10% charge: section 249(4)(a), as incorporated by section 249(6)(c).

In my view, nothing in section 249(6) says that a stock dividend which is chargeable under that section is chargeable at the Schedule F trust rate of 25%.⁴ Whether or not it is so chargeable will depend on whether it falls within section 686. If as a matter of trust law it is trust capital (and not trust income), then it cannot in my view be “income which is to be accumulated”, as the concept of accumulation is a trust concept and involves turning what is income for trust purposes into capital for trust purposes. That which is at its inception trust capital cannot be so converted. Whether or not trust capital might be caught by section 686 on the grounds that it is “payable at the discretion of the trustees or any other person” is partly a question of construction of section 686(2)(a) and partly a question of the terms of the particular trust. If the stock dividend is

³ See section 686(2). Charitable trusts and certain pension trusts are also excluded.

⁴ If it is, the trustees will be taxable on 10/9ths of the value of the stock dividend, with a credit of 10%. This works out at 16.67% of the value of the stock dividend.

income as a matter of trust law, then, assuming that it neither belongs nor is deemed for income tax purposes to belong to someone other than the trustees, such as a tenant for life or the settlor, then it will normally be taxable at the Schedule F trust rate.

4 The View of Richard Bramwell QC

4.1 Mr Bramwell's Main Argument

4.1.1 The Argument

Mr Bramwell's comment is:

"As respects the rate of tax applicable to trustees of a discretionary trust, Finance (No. 2) Act 1997 amends section 686 to apply "the Schedule F trust rate" of 25 per cent to Schedule F income and "Schedule F type" income. This last category includes stock dividends."

Mr Bramwell cites in a footnote as authority Taxes Act 1988 section 686(5A)(e).

4.1.2 Reply to Mr Bramwell

The relevant portions of section 686 are:

"(1) So far as income arising to trustees is income to which this section applies it shall be chargeable to income tax at the rate applicable in accordance with subsection (1AA) below, instead of at the basic rate or, in accordance with section 1A, at the lower rate or the Schedule F ordinary rate.

"(1AA) The rate applicable in accordance with this subsection is-

- (a) in the case of so much of any income to which this section applies as is Schedule F type income, the Schedule F trust rate; and
- (2) in the case of any other income to which this section applies, the rate applicable to trusts.

"(1A) In relation to any year of assessment for which income tax is charged-

- (a) the Schedule F trust rate shall be 25 per cent, and
- (b) the rate applicable to trusts shall be 34 per cent ...”

...

“(5A) In this section “Schedule F type income”, in relation to trustees, means-

...

- (e) income treated as arising to the trustees by virtue of section 249(6)(b) ...”

The crucial words are in section 686(1) “So far as income arising to trustees is income to which this section applies”. If section 686 applies to a stock dividend, then I agree that it will be taxable at the Schedule F trust rate. What section 686 does not say is that it applies to all stock dividends. One has to ascertain whether the conditions of application contained in section 686(2) are satisfied.

4.2 Mr Bramwell’s Criticism of the Alternative View

4.2.1 The Criticism

Mr Bramwell considers the alternative view:

“It is sometimes suggested that a stock dividend received by trustees of a discretionary trust falls outside the charge to income tax if under the terms of the settlement, the stock dividend is capital. In such cases it is argued that the charge under section 686 cannot apply because the stock dividend is not:

“income which is to be accumulated or which is payable at the discretion of the trustees or any other person (whether or not the trustees have power to accumulate it)”

His answer is:

“however, this overlooks the point that section 249(6) applies section 686 by reference to hypothetical income:

“Where a company issues any share capital to trustees in respect

of any shares in the company held by them (or by them and one or more other persons) *in a case in which a dividend in cash paid to the trustees in respect of those shares would have been to any extent income to which section 686 applies*, then-

- (a) there shall be ascertained the amount of income which, if the case had been one in which an individual was beneficially entitled to that share capital, that individual would have been treated under subsection (4) above as having received; and
- (b) *income of that amount shall be treated as having arisen to the trustees on the due date of issue and as if it had been chargeable to income tax at the Schedule F ordinary rate*⁵

Accordingly, whether or not the stock dividend is income for the purposes of the settlement is immaterial."

4.2.2 Reply to Mr Bramwell's Criticism

This, with respect, seems to be a *non sequitur*. It does not follow from the fact that section 249(6) will apply to the stock dividend only if a cash dividend would have been caught by section 686, that the stock dividend itself will be caught by section 686. Moreover, the fact that an amount of income is treated as having arisen to the trustees does not mean that it is income to which section 686 applies.