STRANGE, UNINTENDED AND PERHAPS A LITTLE ABSURD – BUT AT LEAST THEY NOW ADMIT IT…

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The author wrote an article in *Taxation* on 24th August 2006 explaining the potentially absurd results produced by FA 2006, Sch 13, para 3 which provides a new s686A[2] to be substituted for the one in the 2005-06 version of readers' red or yellow books.

Dawn Primarolo has since vindicated the author's view with her statement on 9th October 2006, in which she concluded "This result was not intended and therefore amending legislation will be brought forward, as part of Finance Bill 2007, to amend section 686A appropriately. This amending legislation will be backdated to 6 April 2006 so that the position will be as it should have been from the start."

On a literal approach to interpretation, the wording as currently drafted could have produced a charge to income tax at the trust rate, with no tax credit, in circumstances where the payment would not previously have been taxed as income.

Retrospective legislation passed with the intention to prevent a tax charge is a rare sight but one hopes that it will make it onto the statute books; and have the intended effect of tightening up the wording of the new s686A.

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2 All references are to ICTA 1988 unless otherwise stated.

The new s686A as drafted

The new s686A provides for a **payment made** by a company "on the redemption, repayment or purchase of its own shares" to be "treated **as if it were income to which section 686 applies**": see subs (1) and (2)(a).

This wording makes no reference to a 'qualifying distribution', as its predecessor did and, on a literal reading, it brings within the charge to income tax at the s686 rate *any* payment to trustees by a company in respect of a purchase of own shares, not just qualifying distributions.

An example

The trustees of the X trust hold 100 £1 shares in Y Limited which were acquired by way of a share for share exchange in respect of shares in Z limited.

The trustees' shares in Z limited were issued for their nominal value of £100. On exchange for shares in Y limited, the market value of the Z shares was £1m. Thus Y Limited issued the 100 £1shares at a premium of £999,900.

The trustees later sell all their shares in Y Limited back to Y Limited for £1m.

For distribution purposes, the "new consideration" given by the trustees to Y Limited for their Y Limited shares was the £100 nominal value plus the £999,900 premium. Therefore, on the buy back, the distribution by Y Limited to the trustees is £1m paid less £1m new consideration equals nil (s209(2)(b), s211(5) and s254(6) and (7)).

So, under the predecessor to the new s686A, the payment of £1m would **not** have been brought within s686 because it is **not** a 'qualifying distribution' within the definition provided by s14. Instead it would have been consideration for a disposal of the shares for capital gains tax purposes and taxed as such.

Under the new s686A however, the £1m payment appears to be brought within the meaning of 'distribution type income' in s686, notwithstanding that it is not a distribution within s209.

The result, it is said, is that the dividend trust rate of 32.5% (s686(1A)(a)) applies to the £1m payment and tax of £325,000 is payable.

This result might have been half way towards being acceptable if the trustees were going to be entitled to a tax credit under ITTOIA 2005, s397 bringing the rate

down to 25% of the payment. But, since the payment is not a qualifying distribution, no credit is available in these circumstances.

The intention

The purpose of the new provision, like that of the old, is clearly to bring within s686 amounts that are already income for income tax purposes, including capital amounts that are already deemed to be income for income tax purposes. For example, under the old scrip dividend legislation (s249(6)), broadly, the charge arose because capital was deemed to be s686 income by s249 (and now ITTOIA 2005, ss410 and 411 and see *Howell & Anor v Trippier* [2004] BTR 305) when it would otherwise not have been taxed as income at all.

But on a literal reading, the new provision could have had the additional and obviously unintended effect of taxing capital payments, such as the £1m in the above example, that would not otherwise be income for income tax purposes at all.

Where's the charging provision anyway?

Without amending the new s686A, it would still be possible to form the view that the new s686A does not have this 'unintended' result. Neither s686A **nor** s686 is a charging provision; both provisions apply only to payments which are, or are deemed by some other legislative provision to be, income in the first place. Therefore they have no application to a payment such as the £1m in the above example.

It is obvious from the Ministerial statement on 9 October that the literal view could be that s686 is itself a charging provision. No rhyme or reason is provided in the statement but colleagues of the author also expressed this view. They pointed to the opening words of the section: '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…'

In the author's view however, it's clear from those opening words that there is a charge under s686 if and only if two conditions are satisfied, namely (i) there is income (i.e. income which is either income in nature or is deemed to be income for income tax purposes by another section) arising to trustees; which (ii) is income to which s686 applies.

The £1m payment in the above example does not satisfy condition (i) because it is not income; and it is not deemed to be income by s686A or any other section. All

that s686A does (and then only on a literal reading: see further below) is to deem the payment to satisfy condition (ii).

This view of the interpretation of the opening words of s686, to the effect that the section applies only to income for income tax purposes, is supported by the fact that it goes on to say '**instead of at the basic rate or, in accordance with section 1A, at the lower rate or the dividend ordinary rate.**' The clear inference is that s686 imposes a tax rate on a payment which is already within the charge to income tax and which would otherwise be taxable at some other rate.

The result is that s686A(2)(a) does not have the effect of bringing a capital sum such as the £1m payment in the above example into charge to income tax.

For good measure, it could also be said that subsection (2)(a) does not even deem the £1m to be income to which s686 applies, even though, on a literal reading, that is what it says. For it would be a waste of ink to deem an amount to be **income to which s686 applies** if that amount is capital and not **income arising to trustees**. Instead, therefore, subsection (2)(a) surely applies only to sums which are income for income tax purposes in the first place.

This brings subsection (2)(a) into line with subsection (2)(b) to (j). These apply to, for example "an offshore income gain (within the meaning of s761 of this Act)". S761 provides for the gain to "be treated ... as income ...; and ... be charged to income tax". Another example would be "a gain on a disposal of land to which section 776 of this Act applies". S776 provides for the gain to be treated as income and charged, so the profit would be charged to income tax aside from s686, which merely dictates the rate at which it is to be charged to income tax.

Finally, a glance at the "Explanatory Notes" to FA 2006 reveals that bringing into charge to income tax payments that are not otherwise chargeable to income tax was certainly not intended. The Notes state:

"Paragraph 3 provides for a new s686A ICTA, in order to introduce a common charging mechanism for various types of capital receipt currently assessable to income tax in the trustees' hands under a variety of charging mechanisms."

On the basis of the Explanatory Notes, which are a legitimate aid to interpretation, the context in which a payment made by a company on a share buy-back appears in the section (ie amongst other payments already chargeable to income tax), the Ministerial statement, and with the fact that neither s686 nor s686A is a charging provision, it seems eminently reasonable to say that a literal interpretation of the new 686A(2)(a), according to which capital amounts are brought within the charge

to income tax, must be rejected as not only absurd but also plainly contrary to the intention of Parliament.

What is required to eliminate any doubt that the position is the same as it always has been are the two key words ‘qualifying’ and ‘distribution’.