The Personal Tax Planning Review

STOCK DIVIDENDS AND HIGHER-RATE TAXPAYERS

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The Problem

In certain cases, an individual who receives a distribution of stock from a company is liable to an income tax charge, which is normally equal to the value of the stock taxable. The charge is imposed by Taxes Act 1988 section 249(4). Until 1999/2000 it was accepted that if he were a higher rate taxpayer, the individual was given a credit for the lower rate tax and paid the difference between the lower rate and the higher rate on the value of the stock grossed up at the lower rate. This meant that he would have to pay a sum equal to 25% of the value of the stock.

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 Taxation of Companies and Company Reconstructions that, as from 1999/2000, the rate of tax which a higher rate taxpayer has to pay on a stock dividend is 40% of the gross, or 33% of the net, as opposed to 25% previously.

In this article, we respectfully disagree with that conclusion. We consider that the effective rate of tax remains unchanged. The question is important, as, given the new taper relief regime introduced in the Finance Bill 2000, if we are correct, stock dividend planning is worth considering for this year of assessment 2000/2001, whereas if Mr Bramwell is correct, stock dividend planning is already largely obsolete.

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The Changes to Schedule F

As from 1999/2000, the rules relating to dividends and other Schedule F distributions have been changed, by the amendments made prospectively by Finance (No. 2) Act 1997. The credit is reduced from 20% to 10% of the combined amount of the distribution and the credit and is made non-repayable. The rate at which tax is paid on the dividend, however, is reduced in the case of taxpayers who would otherwise be taxable at the lower or the higher rates. The net result is that such persons pay exactly the same amount of tax as before. The only persons who are prejudiced are persons who would pay no tax on the distribution and who would be entitled to repayment of the whole or part of the tax credit. These were largely charities and exempt funds, United Kingdom resident individuals who had so little taxable income that they did not pay tax at even the lower rate and residents of foreign countries who were entitled to a tax credit under the terms of a double taxation convention.

The Charge on Individuals re Stock Dividends

The Statute

Section 294(4), as currently amended 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-
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> (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;
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> (b) no repayment shall be made of income tax treated by virtue of paragraph (a) above as having been paid; and
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> (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".

The View of Richard Bramwell QC

Mr Bramwell's comment is:

> "Subsection (4)(a) is intended to give credit of 10 per cent. and subsection (4)(c) makes the Schedule F ordinary rate the only rate applicable to non-higher rate taxpayers, but it does not bring section 1B into play for higher rate taxpayers. That is the only provision under which the Schedule F upper rate could be applicable, and *as a stock dividend is not Schedule F income*, section 1B does not apply in the absence of any express intention. Thus, in strictness, the higher rate of 40 per cent. applies".

We disagree with this conclusion, whether or not the stock dividend is properly seen to be Schedule F income, or some other form of non schedular income.

The Rates of Tax

The Statute

In order to understand Mr Bramwell's point, it is necessary to consider sections 1, 1A and 1B of Taxes Act 1988.

> "1 The charge to income tax
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> (1) Income tax shall be charged in accordance with the provisions of the Income Tax Acts in respect of all property, profits or gains respectively described or comprised in the Schedules A, D, E and F, set out in sections 15 to 20 or which in accordance with the Income Tax Acts are to be brought into charge to tax under any of those Schedules or otherwise.
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> (2) Where any Act enacts that income tax shall be charged for any year, income tax shall be charged for that year-

(aa) in respect of so much of an individual's total income as does not exceed £1,500, at such rate as Parliament may determine to be the starting rate for that year;

(a) in respect of any income which does not fall within paragraph (aa) above or paragraph (b) below, at such rate as Parliament may determine to be the basic rate for that year;

(b) in respect of so much of an individual's total income as exceeds [£28,000, pre Budget] such higher rate as Parliament may determine;

but this subsection has effect subject to any provision of the Income Tax Acts providing for income tax to be charged at a different rate in certain cases ...

1A Application of lower rate to income from savings and distributions

(1) Subject to ... so much of any person's total income for any year of assessment as-

(a) comprises income to which this section applies, and

(b) in the case of an individual, is not income falling within section 1(2)(b) [i.e., is not higher rate income],

shall, by virtue of this section, be charged for that year at the rate applicable in accordance with sub-section (1A) below, instead of at the rate otherwise applicable to it in accordance with section 1(2)(aa) and (a).

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

(a) in the case of income chargeable under Schedule F, the Schedule F ordinary rate ...

(2) Subject to subsection (4) below, this section applies to the following income-

(a) ...

(b) any income chargeable under Schedule F ...

1B Rates of tax applicable to Schedule F income

(1) In the case of so much of an individual's income which consists of-

(a) income chargeable under Schedule F (if any), and

(b) equivalent foreign income falling within section 1A(3)(b) and chargeable under Case V of Schedule D (if any),

as is income falling within section 1(2)(b), income tax shall, by virtue of this subsection, be charged at the Schedule F upper rate, instead of at the rate otherwise applicable to it in accordance with section 1(2)(b).

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

(a) the Schedule F ordinary rate is 10 per cent, and

(b) the Schedule F upper rate is 32.5 per cent,

or, in either case, such other rate as Parliament may determine".

Comment

The combined result of this is that, in the case of Schedule F income, an individual who does not pay the higher rate is chargeable at the Schedule F ordinary rate of 10% and a person who does pay the higher rate is chargeable at the Schedule F upper rate of 32.5%. Given that the income comes with a tax credit of one-ninth of the amount paid and the taxable amount is the amount paid plus the tax credit, an individual who is not a higher rate taxpayer has no additional tax to pay whereas a higher rate taxpayer has to pay in addition an amount equal to 25% of the amount paid, just as in 1998/99.

Our Reasoning

If the income encompassed by section 249 is properly seen to be deemed by section 249 to be actual Schedule F income, then it would follow that the Schedule F ordinary and upper rates would apply to it (as would all other provisions which apply to distributions). We consider this to be a perfectly plausible view, although it does, as we point out below, give rise to anomalies. Mr Bramwell is of the view that a stock dividend is not taxable under any

Schedule. That in itself is not remarkable and its possibility is contemplated by section 1(1) (although contrast section 9(3), for corporation tax purposes). It can simply be an amount which falls to be included in one's total income. Indeed, TA 1988, section 686(5A)(a) and (e) expressly distinguishes between income chargeable under Schedule F and income arising to trustees who receive a stock dividend within section 249(6), while section 743(1A)(a) and (f) distinguishes between income chargeable under Schedule F and income arising under [any] of the provisions in section 249. However, this does not, to our minds, conclusively demonstrate that stock dividends are not to be treated as Schedule F income, or, at the very least, income taxed at the Schedule F ordinary and upper rates, for the reasons we give below.

Section 249 is found in Taxes Act 1988 Part VI, which is headed "Company Distributions, Tax Credits etc", under Chapter VI Miscellaneous and Supplemental. The charge under Schedule F is imposed by section 20. Section 20(3) provides:

> "Part VI contains further provisions relating to company distributions and tax credits".

Section 249(4) tells us that, where a company issues any share capital in a case in which an individual is beneficially entitled to that share capital, that individual is to be treated as having received " 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".

Section 249(4)(b) tells us that the individual shall be treated as having paid income tax at the Schedule F ordinary rate on that income.

Section 249(4)(c) tells us that that income is to be treated as if it were income to which section 1A applies as it applies to income chargeable under Schedule F.

Section 294 does not say in express terms either that the income is taxable under Schedule F or that section 1B is to apply to it as if it were. In our view, contrary to Mr Bramwell's view, it is perfectly possible that the stock dividend indeed gives rise to actual Schedule F income and that this is implied in section 249 and section 249(4)(c) in particular. Mr Bramwell considers that "subsection (4)(c) [of section 249] makes the Schedule F ordinary rate the only rate applicable to non-higher rate taxpayers, but it does not bring section 1B into play for higher rate taxpayers...". Thus Mr Bramwell considers that it is section 249(4)(c) which imposes the relevant rates of tax on income within section 249. We do not think

that this is right. Section 249(4)(c) provides that "[the grossed up amount equal to the market value of the stock dividend, deemed to be income, under the preamble to section 249] shall be treated...as if it were income to which section 1A applies as it applies to income chargeable under Schedule F [i.e., as if it were Schedule F income, specified within section 1A(2)(b)]". Section 1A, in turn, specifies the income to which it applies (section 1A(1)(a)), goes on, as a separate matter, to exclude higher rate income (section 1A(1)(b)) and then applies the relevant rates to the appropriate type of income. Section 249(4)(c), by referring to income to which section 1A applies, simply defines the *type* of income (i.e. Schedule F) which section 249 income is (in the knowledge that the recipient of the income is effectively credited with having paid the Schedule F ordinary rate; that is why section 249(4)(c) is "without prejudice to" section 249(4)(a); the reference to section 1A in section 249(4)(c) also has the effect [perhaps weakly] of confirming that a basic rate taxpayer will pay no tax on section 249 income). Section 249(4)(c) does not impose any rate of tax. The income encompassed by section 249(4) is *not* deemed, by section 249(4)(c), to be income "for the purposes of" section 1A. Section 249(4)(c) does not need to impose any particular rate of tax. The deemed receipt of income is simply subjected to the rates of tax which apply to all Schedule F income.

Furthermore, in section 249(4)(a), it is the *individual* who is subjected to the fiction that he has paid tax at the Schedule F ordinary rate. Section 249(4)(a) does *not* subject the income which is deemed to arise to any fiction that it has borne tax. The individual can only be deemed to pay the Schedule F ordinary rate in respect of income which is subject to that rate, i.e. actual Schedule F income, or, at the very least, income which, if not actual Schedule F income, is income taxed at the Schedule F rates. In other words, for the fiction imposed by section 249(4)(a) to work, the income caught by section 249 must be either Schedule F income, or income taxed at Schedule F rates, namely, the Schedule F ordinary rate and the Schedule F upper rate under section 1B (and not the higher rate under section 1(2)(b)). We might add that a provision which grosses up at the Schedule F ordinary rate and gives a credit at the Schedule F ordinary rate self evidently seeks to tax at the rates appropriate to Schedule F.

It follows that the combination of section 249(4)(a) and (c) either deems section 249 income to be Schedule F income or, at the very least, income taxed at the rates applicable to Schedule F.

Pre 5th April 1999, the position would have been this: the preamble to section 249(4) and section 249(4)(a) treated the higher rate taxpayer as receiving income and gave a credit of an amount equal to lower rate tax. The higher rate of tax in section 1(2)(b), which applied to all income, whether or not Schedule F, was then

applied. Post 5th April 1999, the preamble to section 249(4) and section 249(4)(a) still gave rise to income but gave a different credit (at the Schedule F ordinary rate) and instead of section 1(2)(b) applying, section 1B does because section 249(4)(c) and the assumption inherent in section 249(4)(a)) requires the section 249 income to be treated as either actual Schedule F income, or income taxed at Schedule F rates. Both pre and post 5th April 1999, section 249(4)(c) confirmed that a basic rate taxpayer would not bear tax on section 249 income.

It is true that an old fashioned argument might be run on the following grounds:

> We are told that the income is to be ascertained by grossing up the value of the stock at the Schedule F ordinary rate, but that does not mean that it is Schedule F income;
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> Secondly, we are told that the individual is to be treated as having paid tax at the Schedule F ordinary rate, but that still does not mean that it is Schedule F income;
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> Thirdly, we are told that in the case of a non-higher rate taxpayer he is taxable on the income (if at all) at the Schedule F ordinary rate, but that still does not make it Schedule F income;
>
> Finally, although the draftsman treats the income in every other way as Schedule F income, for the purposes of TA 1988 (see below), as he has not expressly said that it is Schedule F income, or to be treated as Schedule F income, for the purpose of calculating tax at the higher rate, it would be wrong to discern that such is his intention.

Fifty years ago, this type of argument would have been listened to with patience by the Courts. It is one which would have appealed to a mediaeval logician or to the nineteenth century Chancery mind - which was still to be found on the 1970's Chancery Courts. In these days of purposive construction, in the light of the context of section 249 (and especially after *McGuckian)*, we predict that it would get nowhere, assuming the Revenue were to advance it. Quite apart from the fact that it is predicated on the mistaken assumption that section 249(4)(c) imposes a rate of tax, rather than simply defining a type of income, the notion that a charge to income tax, buried deep in Part VI, which is concerned with Schedule F Distributions, should not itself be a charge under Schedule F [or, alternatively, a non scheduler charge at Schedule F rates] is so unlikely that one would need to find express provision to that effect. It is worth pointing out that the relevant amendments to section 249(4) were made by F(No.2) A 1997, section 34 and Schedule 4 and that section 34 provides that "Schedule 4 to this Act (*which*

contains provisions relating to tax credits and the taxation of distributions) shall have effect". It is true that there is no express reference in section 249(4) to section 1B, but there is express reference to the Schedule F ordinary rate, and even on Mr Bramwell's view, one has to look to section 1B to discover what that rate is. In other words, section 249(4) must import the application of section 1B, by implication, on any view. The draftsman clearly thinks that section 1B applies to stock dividends; hence the absence of any express reference to the Schedule F ordinary rate in section 249(4), which would otherwise be needed to make the section work. The notion that stock dividends within section 249 give rise to income which is Schedule F income, for all practical purposes, is further reinforced by the provisions in section 686(5A)(a) and (e) and section 743(1A)(a) and (f), to which we refer above, since all they do is to confirm, if there were any doubt, that stock dividends within section 249 and other schedule income chargeable under Schedule F are to be treated in exactly the same way for section 686/739 purposes.

The contrary view, to our minds, produces absurd results. To impose a higher rate charge on a receipt, where the gross up (and credit) under section 249(4)(a) is only at the Schedule F ordinary rate, is to impose a penal rate of tax on a higher rate taxpayer. What conceivable purpose can Parliament have had in taxing stock dividends at a higher rate than all other distributions (or deemed distributions) from companies? The purpose of the 1997 Finance (No 2) Act changes is obvious [to ensure that the treatment of stock dividends was in line with the new Schedule F ordinary and upper rates, so that basic rate taxpayers had no further tax to pay and higher rate taxpayers continued to be taxed at an effective rate of 25%]. It did not require or admit the imposition of a penal rate of charge on higher rate taxpayers in respect of stock dividends.

Absurdity is piled upon absurdity, following the contrary view, if one considers section 743(1)(a), which seeks to impose the tax rates applicable to Schedule F income, on income caught by section 739. Section 743(1)(a) provides that "[tax shall be charged on]...income [specified in section 743(1A)] as if it were income to which section 1A applies by virtue of [section 1A(2)(b) [i.e. income chargeable under Schedule F]". This is identical wording to that in section 249(4), of which Mr Bramwell complains. Section 743(1A) encompasses, as we have already observed above, both "actual" Schedule F income (section 743(1A)(a)) and stock dividend income within section 249 (section 743(1A)(f)). If Mr Bramwell's view, that such wording imposes the Schedule F ordinary rate but leaves the income subject to it to the higher rate in section 1(2)(b), is correct, then "true", *actual* Schedule F (dividend) income is taxable at an effective rate of 33%, if caught by section 739, despite the fact that the draftsman has gone out of his way to distinguish between Schedule F income specified in section 743(1A)

and other income caught by section 739, specifically in the context of imposing rates of tax.

We consider the construction of section 249(4) which produces such absurdities to be wholly implausible and conclude that, given that section 249 (and section 743) admits the construction which we consider to be the better view, that this is the meaning that section 249 actually bears.

Given the context of section 249, this conclusion is overwhelmingly attractive; furthermore, *O'Rourke v Binks* [1992] STC 703 is substantial authority for the proposition that necessary "carpentry" may be done to a tax provision [reading words in, if necessary] to avoid absurdity. Thus the words "or 1B" may be read as impliedly appearing after the reference to section 1A in section 249(4)(c).

It is true that certain anomalies arise if stock dividend is deemed to be actual Schedule F income. For example, a non UK resident would escape UK income tax altogether, on the payment of a stock dividend within section 249(4) (because Schedule F income is "excluded income" within FA 1995, section 128(3)(a)) but that non resident would nevertheless obtain a CGT uplift under TCGA 1992, section 142. We do not consider that this conclusively defeats the argument that a stock dividend is actual Schedule F income. A cash dividend, satisfied *in specie*, would give the non UK resident recipient a UK tax free CGT market value base cost, in the assets received, and we see nothing remarkable about that. However, we acknowledge that such anomalies, coupled with the distinctions drawn by section 686(5A) and section 743(1A) make it perfectly possible that a Court may hold that section 249 income is not actual Schedule F income. We also acknowledge that, in that event, the treatment of section 249 income as Schedule F income would be limited to the purpose of imposing the Schedule F ordinary and upper rates [in other words, section 249 income is non schedular income taxed at Schedule F rates].

Conclusion

While we fully accept that it would have been clearer if section 249(4)(c) had referred to section 1B in terms, as well as to section 1A, we do not think that makes any difference. It is in our view clear from the context and the intendment that income taxable under section 249 is Schedule F income, at the very least for the purpose of applying the relevant rates.