PURCHASE OF OWN SHARES from a company – distribution treatment applicable – whether consideration included in capital gains computation as stated in SP4/89 – yes – appeal dismissed

THE SPECIAL COMMISSIONERS

STRAND FUTURES AND OPTIONS LIMITED Appellant

- and -

PETER WILLIAM LEWIS VOJAK Respondent

Special Commissioners: DR JOHN F AVERY JONES CBE

MALCOLM J F PALMER

Sitting in public in London on Thursday 17 January 2002

Jan Matthews of counsel instructed by Fisher Sassoon & Marks, chartered accountants, for the Appellant

Christopher Tidmarsh of counsel instructed by the Solicitor of Inland Revenue for the Respondents

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DECISION

1. This is an appeal by Strand Options and Futures Limited against an estimated assessment for the accounting period ended 31 December 1995. The Appellant was represented by Mr Jan Matthews and the Respondent by Mr Christopher Tidmarsh.
2. There was an agreed statement of facts as follows:

"1. The Appellant was incorporated on 11 April 1986 under the name Amoptions UK Limited and changed its name to Strand Options and Futures Limited ("the Appellant") in December 1990.

2. On 31 October 1986 the Appellant acquired by allotment 29.9% of the issued share capital of City of London Options Limited ("CLO"). By 1995 the Appellant held 179,400 shares, still comprising 29.9% of the issued share capital.

3. On 31 March 1995, Messrs Fisher Sassoon and Marks, the agents for CLO and the Appellant ("the agents") made clearance applications under s707 Taxes Act 1988 and s225 (1) (b) Taxes Act 1988 in relation to the Appellant’s proposal to dispose of its shares in CLO.

4. It was proposed that the Appellant would sell 50% of its share holding in CLO to Financielle Participaties Amsterdam BV ("FPA") for £871,630 and that CLO would purchase the remaining 50% of its own shares from the Appellant for £871,630.

5. Under s707 (1) (b) Taxes Act 1988 the Board may confirm whether or not s703 Taxes Act 1988 applies to a transaction in securities. Section 703(1) Taxes Act 1988 applies in the circumstances specified in s704 Taxes Act 1988 and where a taxpayer is in a position to obtain a tax advantage because of a transaction in securities, unless he can show that the transaction was carried out for bona fide commercial reasons or in the ordinary course of making investments and that none of the transactions had as their main object or one of their main objects the obtaining of a tax advantage. If s703 does apply the Board serve a notice pursuant to 703(3) informing the taxpayer how the advantage will be counteracted.

6. Under s225(1) Taxes Act 1988 the Board notify a taxpayer whether or not s219 Taxes Act 1988 will apply to the redemption, repayment or purchase of own shares. If s219 applies to a purchase of own shares, the payment will not be treated as a distribution.

7. On 12 April 1995 the Board confirmed that they were satisfied that the provisions of s219 did not apply to the payment to be made by CLO in respect of its purchase of its own shares from the Appellant. On 24 April 1995 the Board confirmed that they were satisfied that the transactions did not require a notice under s703(3) to be given in respect of them.

8. On 29 September 1995 CLO purchased 89,700 of its own shares from the Appellant for £871,630. That payment falls to be treated as a distribution except to the extent that it represents a return of capital originally subscribed, see 209 (2) (b) Taxes Act 1988. FPA purchased the remaining 89,700 shares in CLO from the Appellant for a payment of £871,630.

9. On 17 January 1997 the agents submitted the Appellant's Corporation Tax computation for the accounting period ended 31 December 1995 excluding the distribution received from CLO on its purchase of its shares from the capital gains computation.

10. On 3 February 1997, the Inspector informed the agents that SP4/89 applied to this distribution and that the distribution should be included in the disposal consideration for capital gains purposes.

11. A corporation tax notice of assessment on the Appellant for the accounting period ended 31 December 1995 was issued on 17 September 1997 in an estimated amount of £1.7 million, with net capital gains of £1.6 million.

12. By letter dated 29 September 1997, the agents lodged an appeal against the assessment.

The Issue:

13. The issue to be determined is whether, when the Appellant received a distribution from CLO on CLO's purchase of its own shares in September 1995, that distribution is to be included in the consideration for the disposal of those shares for the purposes of the charge to corporation tax on chargeable gains.

14. The Revenue rely on Statement of Practice SP 4/89 as a correct application of s208 Taxes Act 1988, s8(4) TCGA 1992 and s37(1) TCGA 1992 where a distribution is received by a corporate shareholder on a company purchase of own shares.

SP4/89 appears as follows:

Company Purchase of Own Shares: capital gains treatment of distribution received by corporate shareholder:

"If the purchase of its own shares by a company resident in the United Kingdom gives rise to a distribution, and a shareholder receiving such a distribution is itself a company, the distribution is included in the consideration for the disposal of the shares for the purposes of the charge to corporation tax on chargeable gains. In the Revenue's view the effect of TA s208, TCGA s8(4) is that the distribution does not suffer a tax charge as income within the terms of s37(1) TCGA 92. The Revenue will apply this Statement of Practice where a company purchases its own shares after 19th April 1989."

15. The Appellant contends that no part of the distribution it received from CLO on the share buy-back should be included in the consideration for the disposal of the shares for the purposes of the charge to corporation tax on chargeable gains.

16. There are no issues in dispute except that set out above. If the Special Commissioners allow the Appellants appeal, the assessment should be determined on the basis that the profits chargeable to corporation tax for the accounting period ended 31 December 1995 are £587,692.

    1. If the appeal is dismissed, the assessment should be determined on the basis that the profits chargeable to corporation tax for the accounting period ended 31 December 1995 are £1,431,686."

1. Mr Matthews on behalf of the Appellant put forward three contentions which he summarised in his skeleton argument as follows:

    1. The Appellant contends that a purchase of own shares which is a distribution falls to be excluded from the charge to corporation tax by reason of section 208 of the Taxes Act 1988. There is no distinction between this and any other kind of distribution. The exemption is complete and there is no foundation for bringing in the distribution as a component in a chargeable gains computation.
    2. If this is not accepted, it is further submitted that such a distribution does not in any event fall within the chargeable gains legislation. It would only do so if it were treated as a capital distribution within section 122 of the TCGA 1992, and section 122(5)(b) excludes it from being so. Any other interpretation of the legislation would produce the arbitrary result that profits extracted from a company by a share redemption or dividend would be taxed differently to profits being extracted by a share purchase which was a distribution.
    3. If neither of these submissions is accepted, it is finally submitted that section 37 of the TCGA 1992 applies to avoid a charge to corporation tax on chargeable gains.

1. Mr Matthews first set out the framework of the legislation as it applied in 1995. It is only necessary to mention that until 5 April 1999, where a UK

resident company made a "qualifying" distribution it was required to pay ACT under section 14 of the Taxes Act 1988. According to section 20(1) of the Taxes Act 1988, income tax was chargeable under Schedule F in respect of dividends and other distributions; and for the purposes of income tax, all such distributions are to be regarded as income, however they fall to be dealt with in the hands of the recipient. Distributions were (and are) excluded from the charge to corporation tax by section 208 of the Taxes Act 1988, which states:

"Except as otherwise provided by the Corporation Tax Acts, corporation tax shall not be chargeable on dividends and other distributions of a company resident in the United Kingdom, nor shall any such dividends or distributions be taken into account in computing income for corporation tax."

Section 231(1) of the Taxes Act 1988 provided that where a company received a qualifying distribution it was entitled to a tax credit equal to such proportion of the value of the distribution as corresponded to the rate of ACT then in force for the financial year when the distribution was made. That tax credit could be utilised in the following ways:

i. For exempt companies or where express exemption was given for the distribution otherwise than by section 208 it would be paid to the company under section 231(2).
ii. To "frank" its own distributions; section 241.
iii. To set against losses etc., thereby enabling the credit to be paid to it; section 242.

Section 208 of the Taxes Act 1988

1. Section 208 has already been set out above.
2. Mr Matthews contended that the exemption from corporation tax under section 208 was a complete one in which case distributions cannot be made indirectly chargeable to corporation tax by being included in a chargeable gains computation, as part of the consideration arising on a purchase of own shares. See *Hughes v Bank of New Zealand* 21 TC 472, cited recently by Millett LJ in *Bricom Holdings v IRC* [1997] STC 1179, at pages 1194 and 1195 (section 231(2)(b) confirms that section 208 does provide an exemption).
3. The reference in Section 208 that corporation tax is not chargeable on distributions should be construed widely because corporation tax would not in any event be chargeable as such *on* distributions (regardless of section 208). Thus it is chargeable under section 6(1) of the Taxes Act 1988 on "*profits*", which means "*income and chargeable gains*"; Section 6(4). All items of income thus have to be aggregated in order to arrive at total profits for the purposes of section 9(3). So if distributions were within the charging regime an aggregation of all distributions to arrive at a cumulative figure would have to be made. Therefore strictly speaking corporation tax could never have been chargeable on distributions as such, but only on distributions as a component part of profits. If section 208 must therefore be construed widely to avoid a corporation "income" tax charge, it should likewise be construed to avoid a corporation "chargeable gains" charge.
4. Furthermore he contended that because there is only a single corporation tax charge on total profits of companies (including profits and chargeable gains) there cannot in any event be a separate charge to corporation tax on chargeable gains. Corporation tax being such a single charge, the

exclusion from that single charge under section 208 must extend to any charge on chargeable gains. Construing section 208 in this way produces a coherent construction, reflecting the context and scheme of the legislation: it would effectively put companies on the same footing as individuals.

5. The first limb of section 208 provides a complete exemption from corporation tax. The second limb is commonly found in statutory exemptions (for examples see sections 321 and 331 of the Taxes Act 1988). The purpose of the second limb is to ensure that other non-exempted income is not taxed differently or at a higher rate because the exempt income is included. It has an entirely separate purpose: to exclude distributions in the computation. This is not relevant to the computation of chargeable gains.
6. Mr Tidmarsh contended that Mr Matthews' approach begged the question, which was whether there was a complete exemption. If section 208 provides a complete exemption, then the distribution can not be taxed by the back door by including it in a capital gains computation. The *Hughes* case turned on the construction of the statute. The exemption given was absolute. There was a power in section 46 of the Income Tax Act 1918 for the Treasury to issue any securities "with a condition that neither the capital nor the interest thereof shall be liable to any taxation, present or future...". In the context of such an exemption it is not possible that the interest is exempt only from Case III of Schedule D yet remains taxable as a component of profits taxed under Case I. Section 208 is in less absolute terms and does not use the word exemption. It provides first that no corporation tax shall be chargeable on distributions, and secondly that no such distributions be taken into account in computing income for corporation tax. The second limb is expressly limited to tax on income and deals with the point in *Hughes*. The first limb says that there is no tax *on* distributions. The first limb prevents a charge under Schedule F on distributions and the second limb prevents the distribution being included in a computation of profits. He disagrees with Mr Matthews' interpretation of the second limb as being to ensure that other income is not taxed differently nor at a higher rate because the exempt income is included. If that is right it is defective because, for example, distributions are included in calculating the relevant maximum amounts for the small companies rate of corporation tax (see section 13(7) of the Taxes Act 1988). He drew attention to the origin of section 208 in section 47(1) of the Finance Act 1965 where the current section 208 was the first part of the subsection and what is now paragraph 1 of Schedule F in section 20(1) was the second part. It originally read as follows:

   "(1) Except as otherwise provided by this Part of this Act, corporation tax shall not be chargeable on dividends and other distributions of a company resident in the United Kingdom, nor shall any such dividends or distributions be taken into account in computing income for corporation tax; but income tax for a year of assessment after the year 1965-66 shall be chargeable under a new Schedule F in respect of all dividends and other distributions in that year of a company resident in the United Kingdom which are not charged under Schedule D or Schedule E and are not specifically exempted from income tax, and for purposes of income tax all such distributions shall be regarded as income, however they fall to be dealt with in the hands of the recipient."

   This made it clear that the exemption is limited to Schedule F and inclusion in the computation of profits.

Reasons for our decision

7. We find this a difficult question. Our difficulty is supported by the fact that SP4/89 reflects a change from the Revenue's initial position, and, we were told, is disputed by textbook writers.
8. If section 208 is intended to give a complete exemption why is it stated to apply "except as otherwise provided by the Corporation Tax Acts", any why is the first limb worded to exclude tax *on* distributions and the second limb to refer only to income? Mr Tidmarsh referred us to the origin of section 208 in section 47 of the Finance Act 1965. Although the question whether we were entitled to look at pre-consolidation legislation was not argued we consider that we are entitled to look on the ground that, while it is not permissible as a matter of course to refer to the earlier legislation, it is permissible to do so if the consolidated legislation is ambiguous or obscure, see *R v Secretary of State for the Environment, Transport and the Regions, ex p. Spath Holme Ltd* [2001] 2 WLR 15 (see also the application of those principles in relation to tax legislation in *Padmore v IRC (No.2)* [2001] STC 280). Lord Cook in the *Spath Holme* case at p.40 regarded a provision as ambiguous if reasonably open on orthodox rules of construction to more than one meaning. We consider this to be the case particularly as SP4/89 reflects a change in the Revenue view and the Revenue's interpretation is disputed by textbook writers. The original legislation makes it clear that a new charge was being imposed under Schedule F on distributions that were not exempt or chargeable under another Schedule; this was subject to corporation tax not being charged *on* distributions under Schedule F nor their being taken into account in computing income. It is perfectly accurate to say that corporation tax is not charged under Schedule F on distributions, meaning that distributions are left out of account, even though the ultimate charge to corporation tax is on total profits. The context has nothing to do with taxing capital gains. Accordingly, we prefer Mr Tidmarsh's approach that section 208 cannot prevent inclusion of the distribution in the computation of capital gains.

Whether there is an actual disposal on a purchase of own shares

9. Mr Matthews contended that although the Companies Acts legislation is couched in terms of a purchase of own shares, there is no actual sale or purchase, in the sense of a transfer and acquisition of the shares. There is simply a cancellation of the shares under section 160(4) of the Companies Act 1985 as on a redemption of shares. The Revenue accept that there is no actual disposal on a redemption, even though the shares are cancelled. This is further acknowledged by the change in the stamp duties legislation in section 66 of the Finance Act 1986 to bring into charge as a conveyance on sale amounts received on a purchase of own shares. Thus there is no actual disposal of shares, only a deemed disposal to which section 122 of the Taxes Act 1992 prima facie applies. But section 122 does not apply here because section 122(5)(b) excludes distributions within section 20 of the Taxes Act 1988, whether received as dividends or as proceeds of a purchase of own shares.
10. Mr Tidmarsh contended that it is clear from the following provisions of the Companies Act 1985 that there is an actual disposal on a purchase of own shares. Section 164(1):

"A company may only make an off-market purchase of its own shares in pursuance of a contract approved in advance in accordance with this section or under section 165 below."

Section 162:

"(1) Subject to the following provisions of this Chapter, a company limited by shares...may, if authorised to do so by its articles, purchase its own shares (including any redeemable shares).

(2) Sections 159 to 161 [which deal with redemption of shares] apply to the purchase by a company under this section of its own shares as they apply to the redemption of redeemable shares...."

Section 160(4):

"Shares redeemed under this section shall be treated as cancelled on redemption...."

Section 169(1):

"Within the period of 28 days beginning with the date on which any shares purchased by a company under this Chapter are delivered to it, the company shall deliver to the registrar of companies for registration a return in the prescribed form...."

11. Mr Tidmarsh contended that the contract was for the company to purchase the shares as the expression "purchase by a company of its own shares" indicated. The shares are delivered to the company pursuant to the contract and are immediately cancelled. This amounts to an actual disposal of the shares by the shareholder to the company. The reason for the specific stamp duty charge is no transfer that could be stamped is required, not that there is no acquisition by the company.
12. Mr Matthews in reply contended that no vesting of the shares in the company occurred on a purchase of own shares.

Reasons for our decision

13. It is not necessary for us to decide whether a disposal always requires a corresponding acquisition. Nor is it necessary for us to decide whether there is, or is not, any disposal for capital gains tax when shares are redeemed under powers in section 159 of the Companies Act 1985. We have no doubt that a contract for the purchase of its own shares by a company within its powers under section 162 of the Companies Act 1985 is an actual disposal by the shareholder for these purposes. The shareholder has entered into a clear contract to dispose of all rights in and title to the shares. If there was any doubt that there is sufficient evidence of any necessary acquisition by the purchasing company, that is removed by the provisions of sections 162 to 169 of the Companies Act 1985 that Mr Tidmarsh referred us to.

The application of section 122 of the TCGA 1992

14. We consider next whether there is an exemption under section 122 of the TCGA 1992:

"(1) Where a person receives or becomes entitled to receive in respect of shares in a company any capital distribution from the company (other than a new

holding as defined in section 126) he shall be treated as if he had in consideration of that capital distribution disposed of an interest in the shares....

1. In this section—...

(b) 'capital distribution' means any distribution from a company, including distribution in the course of dissolving or winding up the company, in money or money's worth except a distribution which in the hands of the recipient constitutes income for the purposes of [corporation tax]."

1. Mr Matthews contended that where there is a disposal of shares which involves a distribution (e.g. a purchase of own shares or a liquidation) the matter must fall within section 122, since this section applies to all distributions other than income distributions falling within section 209; see section 122(5)(b). See also *O'Rourke v Binks* 65 TC 165. Since section 122 is part of the legislation specifically applicable to shares it must override any general rules in the Act regarding the computation of chargeable gains.
2. Mr Tidmarsh contended that since there is an actual disposal there is no need to consider whether there is a deemed disposal. He disagreed with Mr Matthews'contention that section 122 was concerned with computation; it merely deemed a disposal in circumstances where otherwise there is no disposal.

Reasons for our decision

3. Having decided that there is an actual disposal, we agree with Mr Tidmarsh that there is no need to consider section 122.

Section 37 of the TCGA 1992

4. Section 37 of the TCGA 1992 as modified by section 8(4) provides:

   "There shall be excluded from the consideration for a disposal of assets taken into account in the computation of the gain any money or money's worth charged to corporation tax as income of, or taken into account as a receipt in computing income or profits or gains or losses of, the person making the disposal for the purposes of the *Corporation Tax Acts* [being "the enactments relating to the taxation of the income and chargeable gains of companies and of company distributions (including provisions relating also to income tax")]"; see section 831(1)(a) and (5) Taxes Act 1988.

5. Mr Matthews contended that the Revenue's interpretation resulted in a different treatment of distributions for companies and individuals. He submitted that as there is in principle no difference between the determination of chargeable gains for companies and other persons, the computation provisions which apply for individuals and other persons should equally apply to companies. Thus precisely the same principles should apply for corporation tax. A receipt which is treated as income for tax purposes (with tax effectively deducted at source under the ACT procedure) should not also be brought into the computation of a capital gain. Otherwise, there would be an artificial distinction between companies and individuals (and also double taxation).

6. Confirmation of the principle of assimilation of treatment of companies to individuals and other persons in determining what constitutes a capital gain is provided by section 8 of the TCGA 1992, in that:

   (i) capital gains principles are to be applied; section 8(3);

   (ii) references in the capital gains tax legislation to income tax are to be construed as a reference to corporation tax; section 8(4);

   (iii) capital gains tax and corporation tax are to be treated as if they are one tax; section 8(5).

7. He contended that what is simply the mechanics of assimilating the treatment of companies to all other persons in a single paragraph by "shorthand" cross-references should not be construed so restrictively. The legislation should be construed in a purposive manner so that companies and individuals are treated in the same way.
8. In relation to the second limb of section 37, first, distributions are taken into account as income in determining whether a company has franked investment income (see section 238(1) of the Taxes Act 1988) treated as profits for section 242 which can be set *inter alia* against trading losses and the other matters referred to in section 242(2), so enabling the ACT to be recovered. This is also relevant in reducing losses which in turn reduce the amount of trading profits actually chargeable to corporation tax in succeeding periods. Secondly, for the purpose of the small companies rate in section 13 of the Taxes Act 1988, a distribution which is franked investment income has to be taken into account in determining whether profits exceed the "lower relevant maximum amount"; section 13(1) and (7). Thirdly, such a distribution would have been relevant for statutory apportionment or shortfall purposes prior to their abolition - and the computation of required distribution levels and shareholders' income tax. In interpreting section 37 of the Taxes Act 1992, Mr Matthews contended that the matter cannot turn on the accident of whether, for example, in the particular period the company had incurred trading losses or had, say, excess charges on income etc. and was therefore able to utilise the surplus franked investment income, or was potentially eligible for the small companies rate. Section 37 must be construed in such a way that it applies generally to include distributions which are franked investment income.
9. Mr Tidmarsh contended that the distribution was not charged to corporation tax as income in the first limb, nor was it taken into account as a receipt in computing income or profits for the purposes of the Corporation Tax Acts for the second limb. He agreed that in Mr Matthews' examples, the income was taken into account but he contended that it was not taken into account *as a receipt* in computing income. Under section 242 of the Taxes Act 1988 the distribution was treated "as if it were a like amount of profits chargeable to corporation tax" rather than as a receipt. In section 13 the distribution was taken into account in determining the lower relevant maximum amount but was not taken into account as a receipt in computing profits. While there is no distinction in principle between a purchase of own shares from a company and from an individual the result is different since companies are not taxed on distributions and individuals are taxed.
10. In reply, Mr Matthews contended that distributions are taken into account as a receipt in computing franked investment income and for the small

companies rate. There is no requirement that the distribution should actually be taxed.

Reasons for our decision

11. We prefer Mr Tidmarsh's approach. Section 37 excludes from the computation of capital gains sums actually taxed as income or taken into account as a receipt in computing profits that are taxed. Here the distribution was neither taxed nor included as a receipt in the computation of profits so section 37 does not exclude it from the computation. The result is what one would expect; if the sum is taxed as income or included in a computation of profits that are taxed as income, it is not charged as a capital gain. In this case as there has been no direct or indirect charge to tax as income there is nothing to prevent a charge as a capital gain.

Result

12. In summary our decision is that –

1. section 208 of the Taxes Act does not exempt the distribution element in a purchase of own shares from tax as a capital gain;
2. there is an actual disposal on the purchase of own shares that is taxed as a capital gain;
3. section 122 of the TCGA 1992 is inapplicable;
4. section 37 of the TCGA 1992 does not exempt the distribution from being taxed as a capital gain.

Accordingly we dismiss the appeal and confirm the assessment in the agreed figure of £1,431,686.

JOHN F AVERY JONES

MALCOLM J F PALMER

SPECIAL COMMISSIONERS

SC3098/01

Authorities referred to in skeletons and not referred to in the decision:

20 Cannon Street v Singer Limited [1974] 1 Ch 229

Chevron v IRC [1995] STC

Ramsay v CIR 54 TC 101

Bibby v Prudential Insurance [2000] STC 459

Bird v IRC [1988] STC 312

IRC v Colmer [1993] STC 710 (CA)