DIVIDEND

WAIVERS

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Dividend waivers

Produced by Tolley

In certain circumstances shareholders may wish to pay dividends other than in proportion to their shareholdings. This aim is typically achieved by one or more shareholders not taking a dividend when it is declared. To effect this, the relevant shareholders must waive their right to dividends from the company prior to the dividend being declared.

Care must be taken when waiving dividends. HMRC may attack this where there is a loss of tax as a result.

In order to minimise the risk of HMRC scrutiny when effecting a dividend waiver, the following measures should be taken:

- The waiver must be effected by a deed
- The deed must be executed before the dividend is declared or paid (otherwise the dividend will not be waived and the income will be taxed as the shareholder's income anyway)
- The waiver must be 'commercial'

The first two points relate to ensuring that the dividend waiver is effective for the purpose intended. That is, if the waiver is not effected by deed or done retrospectively, the shareholder will still be entitled to the dividend when it is paid. The shareholder will likely have under-declared dividend income on their tax return.

The third point relates specifically to the settlements legislation. HMRC will consider that the lack of commerciality of a waiver is an indication that there is an element of 'bounty' which is a sufficient characteristic indicative of a settlement.

TSEM4220

Dividend waivers and settlements

The settlement provisions are of particular relevance to dividend waivers. When planning dividend waivers you should always consider the application of the settlements legislation. Where the rules apply, dividend income of another individual becomes income of the shareholder waiving his right to dividends. This will usually return dividend income to what it would have been had the waiver not been in place, though this is not necessarily the case.

The definition of a settlement is widely drawn to include any 'disposition' or 'arrangement'. This would include any transfer of assets between parties, including rights to income. A dividend waiver may effectively transfer a right to income and is therefore susceptible to the settlement provisions. Where the arrangement is found to be a settlement the waiving shareholder would be considered to be the settlor.

ITTOIA 2005, ss 619-620

The settlement provisions specifically apply to dividend waivers where a settlor retains an interest in income derived from property that they have given away. The property in this instance, potentially, is a right to income. The retained interest will arise where the waiving shareholder may still benefit from the dividend income. This is obviously a distinct possibility where the spouse or family member receives an enhanced right to income from a dividend waiver.

ITTOIA 2005, ss 624-625

However, there is no requirement that the recipient of the income is a connected person in relation to the settlor, although a settlor is always regarded as retaining an interest in property which yields income to their spouse or civil partner. This means that any situation where shareholders might collude to collectively reduce their tax burden can be caught.

Much of this reasoning has been supported by the decision in the *Buck* case, discussed further below. In this case it was found that a dividend waiver constituted a settlement due to it containing the requisite element of 'bounty'. The term 'bounty' derives from case law in connection with settlements and has consistently been used as a test for the existence of a settlement, most notably in the *Arctic Systems* case. Essentially it refers to a benefit conferred on the beneficiary that they would have not otherwise have received from an arms length transaction. This has become known as the 'element of bounty' test.
Buck v HMRC [2009] STC (SCD) 6 Jones v Garnett [2007] STC 1536.

The *Buck* case also determined that a dividend waiver did not benefit from the exception that applies to outright gifts between spouses. This was because the gift was wholly or mainly a right to income, failing by virtue of what is now ITTOIA 2005, s 626(3).

Buck v HMRC

The decision in *Buck v HMRC* examined the question of whether a dividend waiver can constitute a settlement for income tax purposes under ITTOIA 2005, ss 624-625.
Buck v HMRC [2009] STC (SCD) 6.

Mr Buck owned 9,999 shares in a family trading company and the remaining share was held by his wife. Shortly before the company's year ended 31 March 1999, Mr Buck waived his dividend entitlement by formal notice in writing and a dividend of £35,000 per share for that year was then paid out, all of which went to Mrs Buck. They did the same for the following year.

HMRC argued that the two dividend waivers in 1999 and 2000 and the subsequent payments to Mrs Buck represented an arrangement for the purposes of ITTOIA 2005, s 620 so that the anti-avoidance settlement legislation applied.

HMRC considered that the let-out in ITTOIA 2005, s 626 (by way of an exception for outright gifts between spouses) was not in point, given that the arrangement did not represent an outright gift of income-producing property from one spouse to the other and, in any event, the subject-matter of the gift was wholly a right to income. The taxpayer (who was unrepresented and did not attend the hearing) claimed that there was no arrangement – it was in the company's interest to pay out the maximum dividends available and he had not wanted to receive them.

Unsurprisingly, the Special Commissioners found HMRC's arguments convincing, with the result that the waived dividends were treated as Mr Buck's income and so were taxable on him. It should be noted that ultimately the Special Commissioners followed the approach laid down in the *Arctic Systems* case and asked the question as to whether the arrangements would have been entered into with an arms length third party. The answer in the case of *Buck* was clearly not. This was the decisive line of reasoning with regards to the bounty test.

As discussed above it has always been considered that a dividend waiver can be a settlement when there is an element of bounty. An element of bounty will almost certainly exist where the waiver enables another shareholder to receive an increased dividend, but this does not necessarily mean that every dividend waiver will be caught by the settlement provisions. A dividend waiver has been described by one commentator as 'the abandonment of a contingent right so that the relevant shareholder does not receive the dividend'. It is not a necessary consequence that other shareholders receive more as a result.

A common situation where a waiver would lead to bounty is where a total dividend of a fixed monetary amount is proposed and one shareholder waives his entitlement. In this scenario, the whole of the fixed sum will then go to the remaining shareholders and they will receive more than they otherwise would. That would represent bounty and the settlement provisions could of course apply.

Alternately, if a dividend is proposed of a fixed amount per share, the fact that one shareholder waives his entitlement does not increase the amounts payable to the others. In those circumstances, there is not necessarily bounty and there may be no settlement.

If a dividend per share is proposed which is manifestly in excess of the company's distributable profits, the whole arrangement will be a settlement, as in the *Buck* case. The amounts payable to the other shareholders will only be possible because the proposed dividend will have been made in the clear knowledge that the waiver would take place.

Donald & McLaren v HMRC

The reasoning outlined in the *Buck* case has subsequently been cited in the *Donovan and McLaren* case. This case again relates to dividend waivers made in order to shift income to spouses.
TC03188: Mr P Donovan & Mr P McLaren [2014] UKFTT 048 (TC).

This case is a First-tier Tribunal decision and does not create a binding precedent. It may be persuasive in future cases but is primarily of note for how HMRC pursued their arguments against the taxpayer and what action they might take to recover tax from prior years.

The facts, briefly, were that Mr Donovan and Mr McLaren were each 40% shareholders in Victory Fire Limited, with their wives both holding 10% of shares. At the beginning of 2009/10, both Mr Donovan and Mr McLaren waived dividends on their shares for one day. An interim dividend was then issued which was paid only to their wives. Two days later, Mrs Donovan and Mrs McLaren waived their rights to dividends on their shareholdings for a single day and interim dividends were paid to the husbands.

In both cases there were insufficient distributable reserves to pay dividends to all shareholders in absence of the waivers. HMRC argued that this fact, combined with the lack of commerciality of the arrangements, showed that the element of bounty test was met. Furthermore, HMRC gave evidence that considered several years on a cumulative basis the lack of retained profits compared to dividends without waivers.

The Tribunal did not find the point regarding distributable reserves entirely conclusive in itself. Instead it relied more heavily on the lack of commerciality. The First-tier Tribunal found *as a fact* that there was no commercial purposes for the waivers and that they would not have taken place on an arms length basis.

In deciding that the outright gift to spouse exception in ITTOIA 2005, s 626, the Tribunal found that the case was distinguished from the *Arctic Systems* case for the same reason as the principal reason given in the *Buck* case. That is, there was no outright gift of property.

In addition to the question of whether the settlements provisions applied, the Tribunal found that HMRC were able to raise discovery assessments into the two preceding years. In its argument, HMRC noted that a hypothetical officer of the Board could not have reasonably been expected to be aware of the dividend waivers as the taxpayers' returns for the relevant years did not state that dividend waivers were in place.

This suggests that shareholders who have executed dividend waivers ought to include relevant information relating to the dividend waiver on the return. This should be made in the additional information white space, box 19 and should include, as a minimum, the following information:

- duration of dividend waivers in place during the year
- dividends per share voted by the company during the year, and
- the taxpayers shareholdings

In its argument, HMRC does not indicate that it would expect to be informed of any shareholdings receiving dividends in which the taxpayer might have a retained interest. However, it may be readily anticipated that a hypothetical officer would also require information regarding the spouses' shareholdings and receipt of dividends in order to be expected to be aware of any insufficiency in this, or any similar, instance. Therefore, you should carefully consider what further information may be relevant to protect against a future discovery assessment.

Preparing dividend waivers

At TSEM4225 HMRC sets out factors that it considers are highly indicative of the existence of a settlement. HMRC specifically looks for indications such as these, including the following factors:

- insufficient retained profits to pay dividends
- successive waivers effected in several years with retained profits being insufficient to pay dividends in absence of cumulative waivers
- waiving shareholders could reasonably be regarded as seeking to benefit non-waiving shareholders
- non-waiving shareholders paying tax at a lower rate, and
- other evidence indicating that the taxpayers were seeking to pay a different rate to shareholders in absence of the waiver

TSEM4225

From the *Buck* and *Donovan & McLaren* cases you can see that these factors were considered only to be indicative of an element of bounty. In neither case was this considered to be conclusive evidence of the existence of bounty and therefore a settlement. The main test used in both cases is actually an arms length test or commerciality test. Therefore, the factors HMRC look for may be mitigated through evidence provided by the taxpayer.

In both the cases discussed, the taxpayers were unable to provide any persuasive evidence that dividend waivers were for 'non-tax' reasons.

If dividend waivers are to be used, it would be beneficial to document and evidence any commercial reasons that the shareholder has for waiving the right to dividends. The standard of proof, as stated in the *Donovan & McLaren* case, is on the balance of probabilities. The quality of evidence provided by the taxpayer may prove crucial should the matter be considered by a Tribunal. As always, contemporaneous evidence is likely to be considered more persuasive than evidence produced retrospectively.

In terms of reducing the risk of an HMRC enquiry arising in the first place, it is advisable to avoid any of the indicators mentioned above. Some of these indicators can be avoided simply by following the procedures for paying a valid dividend as discussed in the Dividends guidance note. Others may require a bit more planning. For example, to ensure that cumulatively dividends *in absence of the waivers* do not exceed retained profits, the cumulative effect of dividend waivers should be recorded and retained on the shareholders' and company's files.

Other anti-avoidance provisions

Although dividend waivers are mainly targeted by the anti-avoidance provisions, there are other potential issues.

The Ramsay principle

Dividend waivers may also be targeted using a *Ramsay* type argument, as cited in the *PA Holdings* case. The *Ramsay* principle is presently best described using the quotation from Ribeiro PJ in *Collector of Stamp Revenue v Arrowtown Assets Ltd* 6 ITLR 454:

> The ultimate question is whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically.

It is conceivable that this line of argument could be used where dividend waivers are being used to provide individuals with income that might conceivably have been initially intended as bonuses. As in *PA Holdings*, it might be argued that *viewed realistically* payments are actually emoluments. This case is discussed further in the Dividends guidance note.
PA Holdings Ltd v Revenue and Customs Commissioners [2012] STC 582

The GAAR

There have been no cases involving the GAAR in relation to dividend waivers, but it is possible that dividend waivers could be targeted using the general anti-abuse rule. See the The general anti-abuse rule (GAAR) guidance note for more information.

Disguised remuneration

Similarly, no case has arisen where dividend waivers have been targeted using the disguised remuneration rules. However, as seen in the cases above, dividend waivers fall within the term 'arrangement' and could fall within these rules.

A dividend waiver is effected by a third party, the shareholder of an employing company. A waiver made which benefits a specific employee shareholder could therefore be seen as the relevant step by a third party in providing an employee with a reward in connection with their employment.

ITEPA 2003, Part 7A

See the Disguised remuneration guidance note for more information.