FTC/33/2010
[2011] UKUT 174 (TCC)

Stocklending agreement – deduction for management expenses in respect of manufactured dividends – para 1(1), Sch 23A ICTA – Income Tax (Manufactured Overseas Dividends) Regulations 1993 – whether dividends paid by a Cayman Islands company out of share premium account are "dividends" and "overseas dividends" - yes – ss 737A and 730A ICTA – whether a sale of preference shares and a subscription for preference shares is a sale and repurchase of securities – no – appeal dismissed

BEFORE THE UPPER TRIBUNAL
(TAX AND CHANCERY CHAMBER)

B E T W E E N:

THE COMMISSIONERS FOR
HER MAJESTY'S REVENUE AND CUSTOMS

Appellants

and

FIRST NATIONWIDE

Respondent

TRIBUNAL: Mr Justice Warren, President
Judge Edward Sadler

Sitting in public in London on 23 – 25 February 2011

Malcolm Gammie QC, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Appellants

John Gardiner QC and Philip Walford, instructed by Slaughter and May, for the Respondent

Introduction

1. The central issues ("**the Dividend Issues**") in this appeal are whether each of two distributions made by a company registered under the law of the Cayman Islands and resident there, Blueborder Cayman Ltd ("**Blueborder**"), to Anglo Irish Bank Corporation plc ("**Anglo Irish Bank**") was (i) a "dividend" and (ii) an "overseas dividend" for the purposes of the manufactured payments legislation found in Schedule 23A Income and Corporation Taxes Act 1988 ("**ICTA**") and the Income Tax (Manufactured Overseas Dividends) Regulations 1993. We shall refer to these provisions as "**the manufactured payments provisions**". If they were, then corresponding payments, the manufactured dividends, made by the Appellant ("**First Nationwide**") (a wholly owned investment company subsidiary of Nationwide Building Society ("**the Society**")) to the London branch of ABN AMRO Bank nv ("**ABN AMRO**") are deductible by First Nationwide as a management expense; if they were not, then the corresponding payments are not.

2. There is a secondary issue ("**the Repo Issue**") in relation to sections 737A and 730A ICTA (as extended by subsections 737B(5) and 730B(2)(a)). It is whether the statutory language ("buying similar securities") in the context of the repo provisions includes subscribing for new shares as well as buying shares already in issue.

3. In its self-assessment to corporation tax for the accounting period ended on 31 March 2004, First Nationwide had included a deduction of £51m for expenses of management (being the payment of manufactured dividends paid to ABN AMRO pursuant to a stock lending agreement); HMRC made an amendment to the assessment on 23 April 2008 excluding that deduction. First Nationwide appealed to the Tax Chamber of the First-tier Tribunal. The appeal was heard by Judge Roger Berner ("**the Judge**") who gave a written decision ("**the Decision**") which was released on 12 January 2010. He held, in relation to the Dividend Issues, that each of the distributions was a "dividend" and an "overseas dividend". He also held, in relation to the Repo Issue, that "buying similar securities" did not include

subscribing for new shares. HMRC now appeals with permission from the Judge. The Decision can be found on the Tribunal website at http://www.financeandtaxtribunals.gov.uk/Aspx/view.aspx?id=4702

The Facts - agreed

4. The main facts were not in dispute before the Judge and were set out in an agreed statement of facts and issues which he recorded in paragraph 3 of the Decision. For present purposes, we can adopt a slightly shorter summary.

5. Blueborder was a company incorporated and resident in the Cayman Islands. On 24 September 2003 Blueborder's authorised share capital was increased to £110,101, divided into 10,001 Ordinary Shares of a nominal value of £1 each and 100,100 Redeemable Preference Shares with a nominal value of £1 each ("**RPS**"). On the same date it issued to its parent company, Blauwzoom nv ("**Blauwzoom**"), 1,050 Ordinary Shares and 50,050 RPS (the "**First Issued Preference Shares**") in each case at a premium of £999 each (*ie* an issue price of £1,000 per share). Blueborder accordingly raised £51,100,000 for the issue of its shares of which £51,100 represented the nominal value of the shares and £51,048,900 was share premium. The First Issued Preference Shares were overseas securities as defined by paragraph 1(1) Schedule 23A ICTA.

6. The dividend rights attaching to the First Issued Preference Shares under Blueborder's Articles, were:

    a. The right to a dividend out of share premium of £509.49051 per share (£25,500,000 in total) on 29 December 2003 (the "**First Preference Dividend**");

    b. The right to a dividend out of share premium of £509.49051 per RPS (£25,500,000 in total) on 29 March 2004 (the "**Second Preference Dividend**" which together with the First Preference Dividend we refer to as "**the Preference Dividends**");

c. Thereafter, the right to an annual dividend out of share premium of 1 per cent of the paid up nominal amount per share accruing daily;

7. The redemption rights attaching to the First Issued Preference Shares under Blueborder's Articles, were

   a. The right to £1,022.8459 per share (£51,193,437 in total) plus an interest-based amount, if the First and Second Preference Dividends had not been paid;

   b. The right to £524.1996 per share(£26,236,189 in total) plus an interest-based amount, if the First Preference Dividend but not the Second Preference Dividend had been paid;

   c. The right to £19.98 per share (£999,999 in total) plus an interest-based amount, if both the First and the Second Preference Dividends had been paid.

8. The rights to return of capital on a winding-up or otherwise attaching to the First Issued Preference Shares (in priority to those attaching to the Ordinary Shares or any other class of shares), under Blueborder's Articles, were the same in quantum as the redemption rights at paragraph 7 above.

9. The First Issued Preference Shares were then used as follows:

   a. On 24 September 2003 Blauwzoom lent the First Issued Preference Shares to ABN AMRO under a stock lending agreement;

   b. On 25 September 2003 ABN AMRO lent the First Issued Preference Shares to First Nationwide under a stock lending agreement. First Nationwide paid to ABN AMRO a stock lending fee of £325,000. First Nationwide became the legal and beneficial owner of the First Issued Preference Shares. But under the stock lending agreement, it was obliged to deliver shares of an identical type to ABN AMRO on 24 March 2004. It was also obliged, in relation to each dividend paid on the First Issued Preference Shares, to pay a manufactured dividend to ABN AMRO;

c. On 29 September 2003 First Nationwide sold the First Issued Preference Shares to Anglo Irish Bank for £50.3m, paid immediately to First Nationwide in cash;

d. On 29 December 2003 Blueborder duly paid the First Preference Dividend of £25,500,000 to Anglo Irish Bank, the then owner of the First Issued Preference Shares (and the redemption rights and the rights to return of capital attaching to the First Issued Preference Shares were reduced as described in paragraph 7.b. above);

e. Also on 29 December 2003, pursuant to its obligations under the stock lending agreement referred to at sub-paragraph b. above, First Nationwide paid to ABN AMRO a "Manufactured Dividend" (as defined in the stock lending agreement) equal to the amount of the First Preference Dividend (£25,500,000);

f. On 29 March 2004 Blueborder duly paid the Second Preference Dividend of £25,500,000 to Anglo Irish Bank (and the redemption rights and the rights to return of capital attaching to the First Issued Preference Shares were reduced as described in paragraph 7.c above); and

g. Also on 29 March 2004, pursuant to its obligations under the stock lending agreement referred to at sub-paragraph b. above, First Nationwide paid to ABN AMRO a "Manufactured Dividend" (as defined in the stock lending agreement) equal to the amount of the Second Preference Dividend (£25,500,000).

10. On 25 September 2003 First Nationwide and Blueborder entered into a subscription agreement requiring First Nationwide to subscribe by 29 March 2004 at latest for the unissued balance of 50,050 RPS (the "**Second Issued Preference**

Shares") created on 24 September 2003 (see paragraph 5 above), the subscription price being set by reference to a formula explained in the Decision;

11. On 29 March 2004 First Nationwide subscribed for the Second Issued Preference Shares at the price of £1m under the agreement referred to at paragraph 10 above, and used them to repay to ABN AMRO the stock loan of the First Issued Preference Shares by ABN AMRO (see sub-paragraph 9.b. above).

12. At all material times, all of the issued ordinary shares in Blueborder were owned by Blauwzoom which was itself a subsidiary of ABN AMRO.

13. It was common ground that the legal mechanism of the payment of the First and Second Preference Dividends took the form of payments which were dividends for the purposes of Cayman company law and that these dividends were declared and paid out of Blueborder's share premium account. Although HMRC did not (and does not) agree that this determines the nature of the payments for the purposes of the UK tax legislation, there was no dispute between the experts in Cayman law instructed by the respective parties that, as a matter of Cayman law, the payments were dividends: see paragraph 8 of the Decision.

The Facts - findings

14. The Judge heard evidence from one witness of fact, Alison Gayton. In the light of her evidence, he found as a fact that the purpose of the sale of the First Issued Preference Shares to Anglo Irish Bank was to provide funds for the Society's group to use, and that this was with a view to assisting, in the medium term, with the ongoing funding requirements faced by the group from the growth in the Society's mortgage assets in the second half of 2003.

Cayman law

15. The Judge heard evidence from four experts, two on each side. All were partners in or directors of various firms of attorneys at law. They gave evidence about aspects of Cayman company law and about how the Cayman courts would approach case law from other jurisdictions. We will refer to Cayman law and the Judge's findings where necessary. We note here, however, that the Judge set out at paragraph 6 of the Decision the contents of a Joint Memorandum of Agreed

Matters of Cayman law. He dealt with the experts' evidence in relation to the main area of disagreement (namely the nature of the share premium account) at paragraphs 31 to 36 of the Decision. After detailed consideration of their evidence and an examination of statute and case law, he concluded, in accordance with the view of the experts called on behalf of First Nationwide that a Cayman court would determine that the share premium comprised, by the time of the events in question, distributable profit: see the end of paragraph 48 of the Decision. We will need to return to this in due course.

The UK legislation relating to the Dividend Issues

16. So far as concerns the Dividend Issues, the Judge set out the statutory provisions, preceded by some observations about the present case, in paragraphs 12 to 18 of the Decision as follows:

> 12. The relevant legislation is contained in Part XVIII of the Income and Corporation Taxes Act 1988 ("ICTA") and in the Income Tax (Manufactured Overseas Dividends) Regulations 1993 ("the 1993 Regulations"). Part XVIII is entitled "Tax Avoidance", but it is no part of HMRC's case that the appeal must fail on the basis that it is, wholly or in part, a scheme to avoid tax. As Mr Gammie noted in his skeleton argument, although the legislation is found in the Part of the Act that is set aside for provisions that are designed to counter what Parliament regards as tax avoidance, the legislation in question incorporates no relevant tax avoidance or commercial purposes test. The Appellant's reasons for entering into the transaction, the purpose of which I have found was to assist the Nationwide group's funding requirements, are accepted as being of no concern in construing the legislation.
>
> 13. Section 736A makes provision for manufactured dividends and interest by giving effect to Schedule 23A as follows:
>
> > "Schedule 23A to this Act shall have effect in relation to certain cases where under a contract or other arrangements for the transfer of shares or other securities a person is required to pay to the other party an amount representative of a dividend or payment of interest on the securities."
>
> 14. Schedule 23A makes provision for manufactured payments relating to a number of different types of securities. Paragraph 1 is an interpretation provision for the Schedule and relevantly provides as follows:
>
> > "In this Schedule—
> >
> > ...

"overseas dividend" means any interest, dividend or other annual payment payable in respect of any overseas securities;

"overseas dividend manufacturer" has the meaning given by paragraph 4(1) below;

"overseas securities" means—

(*a*) shares, stock or other securities issued by a government or public or local authority of a territory outside the United Kingdom or by any other body of persons not resident in the United Kingdom; ...

"transfer" includes any sale or other disposal;"

15. Paragraph 4 is the principal part of Schedule 23A relating to overseas securities. Paragraph 4(1) provides that:

> "This paragraph applies in any case where, under a contract or other arrangements for the transfer of overseas securities, one of the parties (the "overseas dividend manufacturer") is required to pay to the other ("the recipient") an amount representative of an overseas dividend on the overseas securities; and in this Schedule the "manufactured overseas dividend" means any payment which the overseas dividend manufacturer makes in discharge of that requirement."

16. Paragraph 8 authorises the making of dividend manufacturing regulations to make different provision from that contained within, amongst others, paragraph 4 of Schedule 23A. The 1993 Regulations were made by the Treasury using that power.

17. Regulation 2(1) provides the following relevant definitions:

> "In these Regulations unless the context otherwise requires—
>
> ...
>
> "manufactured overseas dividend" shall be construed in accordance with paragraph 4(1) of Schedule 23A;
>
> "overseas dividend", "overseas dividend manufacturer", … have the meanings given by paragraph 1(1) of Schedule 23A"

18. Regulations 4(1) and (2) relevantly provide:

> "(1) For the purposes of the provisions of the Tax Acts relating to the charge to tax under Schedule D other than paragraph 4(3) of Schedule 23A, a manufactured overseas dividend paid in the circumstances prescribed in paragraph (2)—

> (*a*) shall not be treated as an annual payment pursuant to paragraph 4(2) of Schedule 23A;
>
> (*b*) shall be paid without deduction of an amount on account of income tax;
>
> (*c*) where the maker of the payment is an investment company within the meaning of section 130 of the Taxes Act, shall be treated as if it was an expense of management in relation to that company.
>
> (2) The circumstances prescribed by this paragraph are where—
>
> (*a*) a manufactured overseas dividend is paid to an approved United Kingdom intermediary or an approved United Kingdom collecting agent by an overseas dividend manufacturer who—
>
> (i) is resident in the United Kingdom … and
>
> (ii) is not an approved United Kingdom intermediary; and
>
> (*b*) the manufactured overseas dividend is not representative of the overseas dividend received by the overseas dividend manufacturer.

Approach to construction

17. We must, of course, adopt a purposive approach to the legislation in accordance with the principles described in cases such as *MacNiven v Westmoreland Investments Ltd* [2003] 1 AC 311 and *Barclays Mercantile Business Finance Limited v Mawson* [2005] 1 AC 684. That much is common ground. We do not consider it necessary to repeat yet again the now familiar passage from the speech of Lord Nicholls at [32] on pp 695-696. The law is succinctly summarised by the Judge at paragraph 22 of the Decision:

> "22. In construing these statutory provisions there was no dispute as to the approach I should adopt. As Mr Gammie pointed out, taxing statutes have to be construed purposively according to the reality of the arrangements in question (*Barclays Mercantile Business Finance Ltd v Mawson* [2005] STC 1 at [32]). This does not, as Mr Gammie accepted, give rise to some overriding power to strike down transactions that have no commercial purpose. The correct approach is, first, to decide on a proper construction exactly what transaction will answer to the statutory description, and secondly to decide whether the transaction in question does so (*Barclays Mercantile* at [36]). The ultimate question is whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction viewed realistically

(*Collector of Stamp Revenue v Arrowtown Assets Ltd* (2004) ITLR 454 per Ribeiro PJ at [35]).”

The Dividend Issues

Issue 1: dividends or not?

18. The determinative questions, on the Dividend Issues, are whether the First and Second Preference Dividends were “dividends” and “overseas dividends”. Although we have just referred to “issues” in the plural, First Nationwide see the dispute as relating in reality only to the question whether the Preference Dividends are “dividends” since, if they are not, First Nationwide loses, but if they are, First Nationwide cannot see how it can be argued that they are not also “overseas dividends”. HMRC see the issues as separate.

19. Even if they can be seen as separate issues, they are very closely interlinked. HMRC’s approach of breaking the question down into two issues proceeds on the basis of a possibility that there can be a dividend which is not an overseas dividend. It is common ground that an overseas dividend must be an income receipt chargeable to tax under Case V of Schedule D. If the Preference Dividends are income in the hands of First Nationwide, there can be no doubt, we think that they are chargeable under Case V. Accordingly, the division of the question into the two separate issues seems to contemplate the possibility of there being something which is properly to be called a “dividend” but which is capital in the hands of the recipient. It is tempting to refer to that as a “capital dividend” but that would be to add confusion to an already confusing use of that term. The term “capital dividend” can sometimes be used to refer to a dividend which is paid out of a capital profit; such a dividend, from an English company, is nonetheless income in the hands of the recipient *eg* for trust purposes as well as for tax purposes. It can also be used to refer to a return of capital: in the context of an English company, this will be a distribution pursuant to a reduction of capital pursuant to the statutory procedure. We will therefore avoid using the term.

20. The term “dividend” is not, in any case, defined for the purposes of the manufactured payments provisions. Rather, the word appears within the definition of “overseas dividends”. It is obvious, if we may say so, that “overseas

dividends" are of an income nature; it is indeed common ground, as we have said, that a receipt can only be an overseas dividend if it is chargeable to tax under Case V Schedule D. We do not see therefore how it can be said that a "dividend" within the definition of "overseas dividend" can be anything which is not income in the hands of the recipient. That is why we say the two issues are very closely interlinked.

21. Because they are interlinked, we see it as artificial to compartmentalise the arguments in the way which they have been put forward by HMRC. The main argument in relation to the second issue (*ie* once it is established that there is a "dividend", can it be said the dividend is also an "overseas dividend") is that the payment of the Preference Dividends resulted in a fundamental change to the First and Second Issued Preference Shares (as to which see *IRC v Reid's Trustees* [1949] AC 361 which we consider later). On that footing, the Preference Dividends were, it is said by HMRC, capital in the hands of the holder of First Issued Preference Shares (Anglo Irish Bank, at the time the dividends were paid). But that, it seems to us, is all part and parcel of the question whether they fell within the meaning of "dividend" for the purposes of the definition of "overseas dividend".

22. The case has, however, been argued before us, as it was before the Judge by Mr Gammie, and therefore responded to by Mr Gardiner, on the footing of the two separate issues. We shall deal with it, as did the Judge, on that basis. But in addressing the first issue, we do so ignoring the argument that there was a fundamental change in the First and Second Preference Shares as a result of the payment of the Preference Dividends.

23. We start, then, with the meaning of "dividend" as a matter of ordinary usage in England and Wales. (We refer to "England and Wales" advisedly: the tax legislation we are concerned with relates to the UK, but the company law which is the context in which the notion of "dividend" is to be considered is the law of England and Wales.) Although not necessarily determinative of the meaning of the word in the tax legislation, it is the appropriate starting point. The meaning of the word in the tax legislation is a matter of English law not of Cayman law.

Although Cayman law uses the word “dividend” to cover the distributions made in the present case by Blueborder *ie* the Preference Dividends, it does not follow that the Preference Dividends are therefore “dividends” with the meaning of the UK tax legislation.

24. Cayman company law is in many respects (and unsurprisingly) very close to English company law. The two share many important features and in particular, both laws provide for the creation and registration of companies limited by shares. Under both systems, such companies have what is called “share capital” which is recognised in the company’s balance sheet. Both systems provide for restraints on the reduction of capital and the consequent payment to shareholders. Both systems require that a nominal or par value is attributed to shares which must be paid on allotment of the shares or on a later call on the shareholders, and both provide for the carrying to a separate account – the share premium account – of monies paid for the subscription of shares over and above their par value. As we will see, both systems have, over the years, changed the way in which such excess over par value can be dealt with.

25. One feature of English company law is and always has been that distributions can be made to shareholders only by way distribution of profits (usually by way of dividend or bonus shares), by a reduction of capital pursuant to statutory procedures, or by way of distribution in respect of shares on a winding-up. It is, and has always been the case, that profits include capital profits. Thus, a profit on the sale of a capital asset could form part of the distributable profits of a company just as much as a trading profit. It could be distributed by way of dividend and, if so distributed, would be income in the hands of the recipient shareholder (so that, in a trust with income beneficiaries and capital beneficiaries, it would belong to the income beneficiaries). A dividend out of capital profits does not have any effect on the capital of the company in the sense of the amount paid up on its shares or, in England at least, the amount of share premium account. The payment of a dividend is commonly effected by the well-know mechanism of a declaration of dividend, followed by payment with a mandate or other form of information to shareholders which will express the payment to be a dividend in respect of the shares on which it is paid, and will specify the amount of dividend,

the date on which it is paid, the accounting period in respect of which it is paid, and (at least in the case of a dividend paid on ordinary shares) whether it is an interim or a final dividend for the period in question.

26. It is worth emphasising one point: the nature (capital or income) of a payment in the hands of the payer is not necessarily the same as the nature of that payment in the hands of the recipient: see for instance *Singh v Board of Inland Revenue* [2000] 1 WLR 1421 at 1423, an appeal to the Privy Council from the Court of Appeal of Trinidad and Tobago. In addressing arguments of the taxpayer that the Board was seeking to tax him with income tax on distributions which represented either retained profits which had already borne corporation tax or capital gains which were not taxable, Lord Millett, giving the decision of the Privy Council said this:

> "Their Lordships are not impressed by these arguments. Section 5 charges income tax upon the income *of the taxpayer*. It is a commonplace that what is capital in the hands of the payer may be income in the hands of the recipient."

27. To the same effect is Lord Simonds in *IRC v Reid's Trustee* [1949] AC 361 at 371 and Lord Reid in *Rae v Lazard* [1963] 1 WLR 555 at 567. We will consider the *Lazard* case in more detail later, but at this point we note this passage at the end of the speech of Lord Pearce (at p 573):

> "It has been suggested in argument that foreign law might create colourable labels or machinery whereby it could fix upon a distribution a specious appearance of capital when in truth it should be income and that thus tax could be unfairly avoided. If such a situation arises, it may well be that the English courts would feel entitled to look behind the labels or even, perhaps, behind the machinery itself to find the true substance of the matter. But in the present case the transaction was admittedly genuine and I see nothing in the concept of partial liquidation which is wholly out of accord with the notions of English law."

28. In English law, prior to the commencement of the Companies Act 1948, a premium paid on a subscription for shares could be returned to shareholders by way of payment of a dividend. In *Re Duff's Settlement Trusts* [1951] Ch 721, Harman J was able to say this (at p 724):

> "It is well known that before the Act of 1948 these sums [sums received by companies as premiums on the allotment of their shares] ranked as profits available for payment of a dividend …"

and at p 727 he continued:

> "It is true also that the share premium account itself represents a profit in the sense that the company got more for its shares than their nominal value."

29. When that case reached the Court of Appeal ([1951] 1Ch 923), one finds Jenkins LJ to the same effect saying this (at p 926):

> "There appears to be little doubt that if, before s. 56 of the Companies Act, 1948, came into operation, the company had distributed amongst its shareholders in cash a sum representing premiums received on the issue of shares, the proportion of such distribution attributable to any trust holding of shares would have been income and not capital as between persons successively interested under the trust. ... The share premiums would have been profits available for dividend (see *Drown* v *Gaumont-British Picture Corporation* [1937] Ch. 402), and if any part of them had been distributed by the company otherwise than in liquidation the amount received by trustees in respect of a trust holding would necessarily have been income in their hands, because it was neither a payment in reduction of paid up share capital nor an addition to the shareholders' capital investment in the company, but simply a cash distribution which, no matter how described, and notwithstanding that in the hands of the company it bore the character of a capital, not an income, profit could not in law be anything else in the hands of the recipients than income derived from their shareholdings."

30. Those eminent judges had no difficulty with the proposition that a *dividend* could be paid out of those sums (a premium paid on subscribing for shares). It did not, clearly, strike them as an inapposite word to use. Of course, in talking of "those sums" ranking as profits available for payment of a dividend, Harman J did not mean that the actual monies paid as dividend had to be paid out of the actual monies paid to the company. He was talking about an accounting exercise so that an actual dividend may be paid out of actual assets provided that there are within the company sufficient profits according to its accounts to support the dividend. So that if a person speaks of a distribution (to use a neutral word) being paid out

of share premium account, what is meant is that the actual distribution will be debited in the accounts against (and thereby reducing *pro tanto*) that account.

31. Moreover, as the judgments affirm, such a dividend would clearly have been income in the hands of the shareholder. Accordingly, where the shareholder was the trustee of a family settlement with a life tenant entitled to income and remaindermen entitled to capital, the dividend was to be dealt with by the trustee as income and not capital.

32. But section 56, Companies Act 1948 made all the difference to the result. Since the commencement of the Companies Act 1948, it has not been possible for an English company to pay a dividend out of share premium account. That section took the share premium account out of the category of divisible profit and prevented it being distributable by way of dividend. Accordingly, if a distribution is properly to be made out of share premium account, that can only be done by following a statutory procedure which effectively treats the distribution in the same way as a reduction of capital. The distribution is not a dividend nor is it received by the recipient as income.

33. That is not to say, however, that the ordinary meaning of the word "dividend" has changed. Suppose, for instance, that Jurisdiction X had in 1947 and at all time thereafter a statutory company law code identical to the pre-1948 English code. Prior to the Companies Act 1948, a distribution (being a payment out of distributable profits) could be made, in both Jurisdiction X and in England, out of share premium account by way of dividend. The Companies Act 1948 prevented such distributions being made by way of dividend in the case of an English company. But the company in Jurisdiction X could continue to make such distributions. Those distributions remained dividends within the ordinary meaning of that word. The Companies Act 1948 did not alter the meaning of "dividend": what it did was to treat what at common law was a distributable profit as no longer such so that it could no longer be paid out as a dividend. As *Duff's Settlement* shows, the consequence of the change in the way that share premium account could be distributed was that the receipt, in the hands of the recipient, was capital and not income.

34. Nonetheless, words can change their meaning over time. It is suggested by HMRC in arguing this case that the concept of dividend for the purposes of the Companies Act 1948 and successor legislation up to and including the Companies Act 1985, excludes a dividend paid out of share premium account; and that this is the approach to be adopted generally. It is asserted that this reflects the idea of what the business community would regard as a dividend and is therefore the approach to be adopted in determining whether a sum received by a shareholder is a dividend for the purposes of the manufactured payments provisions. But there is not a shred of evidence to support that assertion. We are happy to assume that the business community in the City of London or Edinburgh and other financial centres in the UK would understand that a dividend could not be paid out of the share premium account of an English company; but equally, the members of that community, if at all sophisticated, might also understand that under some other jurisdictions, including the Cayman Islands, the amount credited to share premium account comprises distributable profits which can be paid to shareholders as dividends. It is far from obvious to us that such people would not regard payments in the latter class as dividends and use that word to describe them.

35. HMRC also place reliance on general descriptions in two English cases. The first is *Esso Petroleum Co Ltd v Ministry of Defence* [1990] Ch 163 where (a different) Harman J was considering the phrase “public revenue dividends”. He said this (at pp 165-6):

> “….I do not believe that any investor, investment manager, banker, stockbroker or even lawyer ever in the last quarter of the 20th century utters the phrase "public revenue dividends." The word "dividends" originally referred to the dividing up of something, usually a profit, among several people so that each had a fraction or share of the whole. The rebate allowed by co-operative societies to members who made purchases at the society's shop was called a "dividend." I believe that the payment out of a share of a football pool to a successful forecaster of the results of matches is called a "dividend." Both these uses refer to sharing out of something.
>
> In ordinary language today among people having some understanding of business a "dividend" refers to a payment-out of a part of the profits for a period in respect of a share in a company. The dividend may be a fixed amount on a preference share or a fluctuating amount on an equity share. It is

> distinguished in the Taxes Acts generally by being accompanied, under the "imputed corporation tax" system operative in the United Kingdom, by a "tax credit." The distinction in both ordinary understanding and in taxation legislation is between "dividends" on the one hand and "interest" on the other, the latter being paid less basic rate tax in contradistinction to the tax credit attributed to a dividend."

36. The second case is *Memec Plc v The Commissioners of Inland Revenue* 71 TC 77, [1998] STC 754 which did no more than adopt what was said in *Esso* namely that the ordinary meaning of "dividend" is that it is a payment of a part of the profits for a period in respect of a share in a company.

37. We do not find those cases of assistance in deciding what is meant by "dividend" either generally or in the special context of the legislation with which we are concerned. The general statements in those cases were entirely apposite in the contexts in which they were made. But the general description has to be qualified on any view. A capital profit is a profit which can be brought into account in deciding what level of dividend it is appropriate to declare. But a capital profit is not made "for a period" in the same way that a trading profit is made which shows that these general words are not to be taken as legislation. It can, in any case, sensibly be said that the "profit" (see *Duff's Settlement*) which accrues when a premium is paid on a subscription is part of the profit for the accounting period during which the subscription is made, although since the Companies Act 1948 came into force, it has not been profit divisible by way of dividend. These cases do not support, albeit, as we accept, they are not inconsistent with, the proposition that a "dividend" as ordinarily understood does not include a payment which is shown as a debit to the share premium account.

38. So having rejected what the business community might understand by, and what two cases have to say about, the ordinary meaning of "dividend" as a foundation for HMRC's case, there is nothing to support the view that the ordinary meaning of the word "dividend" in December 2003 and March 2004 excludes the sort of distribution considered in *Duff's Settlement*. Accordingly, if it were possible for an English company to effect a distribution out of share premium account by the same mechanism as it pays a dividend out of trading profits, that would constitute a "dividend" within the ordinary meaning of the word.

39. Is there any reason, in the light of that, to think that dividends (to use the word actually used in the Cayman Islands legislation) paid out of the share premium account of a Cayman company are not dividends as ordinarily understood? At this point, we need to say something about the Cayman Islands legislation.

40. As originally enacted in 1961, the Cayman Companies Law was modelled on and in similar terms to the Companies Act 1948, and, of particular relevance to this case, included a provision which corresponded to section 56, Companies Act 1948. At that time, therefore, a sum credited to share premium account in the books of a Cayman company did not comprise distributable profits and could not be distributed as a dividend. Such a sum could be distributed only by the machinery for the reduction of capital. And, of course, as a reduction of capital the payment would have been a capital receipt in the hands of the recipient.

41. Then, in November 1989, the Cayman Islands (Amendment) Law 1989 was enacted. It replaced the provision modelled on section 56, Companies Act 1948, expressly providing that the share premium account could be applied:

> "in such manner as the company may…..determine, including, but without limitation – paying distributions or dividends to members…"

42. The power to declare a dividend out of share premium account is subject to a proviso that no such dividend may be paid unless immediately afterwards the company shall be able to pay its debts as they fall due in the ordinary course of business. This is a proviso which is not applicable to dividends payable out of profits such as trading or capital profits or reserves.

43. The experts were agreed on a number of matters in relation to Cayman law relating to companies. These included agreement that (i) share premium is not share capital of a company and that the payment of a dividend is therefore not a return of share capital (ii) prior to a winding up, a company is only permitted to return share capital to its members by a court approved reduction or by a lawful repurchase or redemption (iii) a company may not pay a dividend out of share

capital (iv) there is no income tax or capital gains tax so there is no statutory definition which assists in determining whether any particular payment received is received as capital or income and (v) there is no Cayman authority on whether dividends constitute income or capital in the hands of the recipient: English and other common law authorities would be persuasive. More generally, it was agreed that (vi) where there is no applicable Cayman authority on any subject, the Court will look to English and other Commonwealth authorities which are of persuasive but not binding authority.

44. It is clear from agreed matter (i) that the experts recognised that a "dividend" could properly be paid out of share premium account. They were familiar with the English case law. First Nationwide's experts referred to *Duff's Settlement* expressly pointing out what it said about the possibility, prior to the Companies Act 1948, of dividends being paid out of share premium account. No-one, including HMRC's experts, has at any stage suggested that the use of the word "dividend" in the Cayman Islands legislation in relation to distributions out of share premium account is in any way inapposite or represents an extension of the ordinary meaning of that word. There is nothing here to suggest that a dividend payable out of share premium account is not a dividend as ordinarily understood in England by a commercial man or company lawyer.

45. The Judge reached essentially the same conclusion, although he referred to the "ordinary understanding of that term [dividend] as a matter of legal machinery". He decided that the Preference Dividends were within the meaning of "dividend" in the relevant UK tax legislation. We set out what he said in paragraph 29 of the Decision:

> "….The legislation must be construed purposively, but I can see no basis for ascribing any meaning to "dividend" in this context that is different from the ordinary understanding of that term as a matter of legal machinery. Here it is accepted that the Preference Dividends were lawful dividends as a matter of Cayman law, and that the concepts of that law are analogous to the same concepts under English law. In this respect, therefore, it does not seem to me that the enquiry need go any further. This was not mere labelling; the payments were in substance dividends under Cayman law, the machinery of which is recognisable in the context of English law. Nor is there any question in my view of the machinery of the making of the Preference Dividend

> payments being in any way colourable in the sense referred to by Lord Pearce in *Rae v Lazard*. Lord Pearce was there referring to machinery which might fix upon a distribution a specious appearance, in that case of capital. That goes to the question, not of the nature of the means of payment itself, but of its UK tax treatment, which is the next issue to be considered. And in *Rae v Lazard* Lord Pearce said that the transaction there was admittedly genuine and that he could see nothing in the concept of partial liquidation (in that case under the law of the US state of Maryland) that was wholly out of accord with the notions of English law. That equally applies here. The payments of the Preference Dividends out of the share premium account were genuine, and the machinery accorded with notions of English law."

46. Having said that that was enough to dispose of the first of the Dividend Issues (*ie* whether the Preference Dividends were "dividends" within the meaning of the legislation) he went on to consider the position in case he were wrong on that and on the footing that it is necessary that for a distribution to be a dividend it has to be a payment of part of the profits. We will come to that in a moment.

47. But before we do so, we should address two arguments to the effect that the meaning of dividend in the manufactured payments legislation excludes a distribution out of share premium account. They show that what the Judge said in paragraph 29 is not quite the whole picture and that he may not have been right in saying that "the enquiry need go no further".

    a. The first is that the word "dividend" as used in the manufactured payments legislation, which was passed many years after English law had brought an end to dividends being paid out of share premium, should reflect current English company law by excluding from the scope of "dividend" a payment out of a fund which could not as a matter of English law be made by way of dividend.

    b. The second is this. HMRC say, correctly, that the meaning of "dividend" (and also of "overseas dividend") must be determined in the light of the purpose of Schedule 23A and the other legislation concerning the taxation of manufactured payments. That purpose, according to HMRC, is to deal with the taxation of payments in respect of **income** on shares and securities during the period of a stock loan or repo transaction. And on their view, unblinkered they suggest, the so-called dividends out of share premium comprised a return of amounts originally subscribed as capital to Blueborder.

48. We do not think that there is anything in the first argument. As we have already pointed out (when considering the position in Jurisdiction X: see paragraph 33 above) it is not the concept of dividend which was changed by the Companies Act 1948. Instead, what changed was the nature of the share premium account which ceased to be profit available for distribution and which could thereafter be distributed only by way of the statutory procedure appropriate to a return of capital. But there is no such restriction under Cayman law in respect of the share premium account of a Cayman Islands company. In construing the word "dividend", we think that it is right to consider what the relevant company is actually permitted to do under its governing law rather than what that company would be able to do with its share premium account if it were an English company.

49. Nor do we think that there is anything in the second argument. It is correct, no doubt, that the statutory provisions are concerned with income, but if the distributions are dividends, they are income. The second argument requires one to go behind the legal classification of the receipts in the hand of the shareholder and to examine what, according to HMRC, the payment really represents. It seems to us that, if the second argument is correct, it would apply equally to the distribution of a capital profit realised by the company. But it is surely impossible to maintain that a distribution of a capital profit by way of dividend is not a dividend within the meaning of the manufactured payments legislation.

50. Our conclusion, therefore, is that a distribution out of the share premium account of a Cayman company which is made by the procedure or mechanism of payment of a dividend, is a "dividend" within the manufactured payments provisions. Subject to the second of the Dividend Issues, we therefore agree with the Judge's conclusion that each of the Preference Dividends was also a "dividend" within those provisions. We do so, having disposed of the two arguments with which we have just dealt, for broadly the same reasons as he gave. That is enough to

dispose of the first of the Dividend Issues. It will be noted that, under our approach and analysis, the categorisation in Cayman law of the share premium account as capital or profit is not relevant. Nor is it relevant whether Cayman law would treat a dividend paid out of share premium account as income or capital in the hands of the recipient. In case we are wrong on that, we consider the appropriate categorisation later in this decision.

51. For completeness, we should add that we entirely agree with what the Judge said about labelling both in paragraph 29 of the Decision and, earlier, in paragraph 25. Mr Gammie, however, says that the Judge failed to recognise that Lord Pearce was saying that foreign labels and machinery do not conclusively determine the nature of a payment. Even if those are analogous to English law the enquiry cannot end there. It is necessary to look behind the label to "find the true substance of the matter". We are quite certain that the Judge was well aware that foreign labels and machinery were not conclusive. But what the Judge perceived in Cayman Islands company law were concepts and machinery entirely familiar to an English company lawyer in the context of English company law. There was nothing colourable which would lead to the sort of enquiry designed to find some other "true substance". We reject Mr Gammie's criticism.

52. Indeed, the "true substance" which Mr Gammie professes to find seems to us to be little short of an attempt to establish just the sort of approach to tax avoidance schemes which the courts have rejected. That approach does not seek to establish the true nature of the transaction and then to apply the legislation to it; rather it seeks to re-categorise the steps in the transaction, because there is a tax avoidance scheme, so as to bring the case within the charging provisions of the legislation. Thus we find Mr Gammie, in his written opening, identifying the "true substance" of the matter in this way:

   a. cash was paid into a box (in the form of Blueborder), the key to which was represented by the RPS, and

b. the cash was paid out of that box to the person holding the key 3 months and 6 months later (in the form of the First and Second Preference Dividends).

53. That is not the starting point, or any point along the way, for ascertaining whether the Preference Dividends were within the scope of the terms "dividend" or "overseas dividend" for the purposes of the manufactured payments provisions.

54. We have thus far only considered the meaning of the term "dividend" without having examined in detail the nature, for English law purposes, of the receipt of a dividend paid out of the share premium account of a Cayman company in the hands of the recipient. If the receipt is in fact income, then that of itself suggests strongly, if not conclusively, that the payment is properly to be seen as a dividend for all the purposes of English law. We propose to look at that question when considering the second of the Dividend Issues. As will be seen, we consider that such a receipt is income in the hands of the recipient.

55. At this stage, we turn to consider the position if our approach to the first of the Dividend Issues is wrong and to address the status of the share premium account and whether it forms part of the profits of the company. This is the course which the Judge took in case he was wrong in his primary conclusion as expressed in paragraph 29 of the Decision. The Judge dealt with the issue in paragraphs 30 to 48 of the Decision. He first set out relevant conclusions to be drawn from the Joint Memorandum agreed by the experts which he had set out in paragraph 6. He then summarised the views of the experts for the parties which we have already mentioned: see paragraph 15 above.

56. Before considering the substance of the disagreement between the experts concerning the categorisation of share premium account, the Judge dealt with a particular point of disagreement concerning the nature of the solvency test which had to be satisfied before a dividend could be declared out of share premium account *ie* that the company must be able to pay its debts as they fall due in the ordinary course of business, with criminal sanctions in a case of breach. The experts for First Nationwide were of the opinion that this was not more that a re-

statement of the common law position regarding payment out of “normal profits”. The experts for HMRC were of the opinion that in the case of a dividend paid otherwise than out of share premium account, a cash flow insolvency test was only one of the factors to be taken into account.

57. The relevance of the answer to this disagreement is rather peripheral, it seems to us. If the experts for HMRC are correct, then HMRC are able to point to a potential difference between the situations when the two different types of dividend can be made. But that difference, even if it exists, seems to us insignificant, even when taken with all other relevant factors, in terms of any impact on the questions whether a dividend paid out of share premium account is received as income or capital or whether the share premium account itself is to be seen as akin to share capital rather than profit. This is particularly so given that even HMRC’s experts accepted that a cash flow solvency test was one of the factors to be taken into account by the directors in exercising their fiduciary duties on the occasion of any payment of a dividend.

58. The Judge in effect took the same view. His actual decision on the point came down on the side of the experts for First Nationwide but it made no difference to his conclusion on the substantive issue which was that the share premium account was not akin to capital but was profit. Thus he said at paragraph 48:

> “….Even if I had accepted that a Cayman Islands court might consider that the solvency test in section 34 is not identical to the test that a company or its directors might be required to apply on a distribution of “normal profits”, the inclusion of the solvency test in section 34(2) is, in my view, no indication that the law intended the character of share premium to be transmuted from its normal character of profit into that of capital, or some special intermediate category of distributable share premium distinct from profit…”

59. We do not, therefore, propose in this already over-long decision, to deal with this point any further.

60. We turn now to the question of the proper categorisation of the share premium account – whether it is akin to share capital or whether it is profit. The answer to that question, of course, depends on what is meant by capital or profit. The

authorities (which we consider below) all regard capital and profit as covering between them the entire ground – there is no third category. Thus in the well-known case of *Hill v Permanent Trustee Company of New South Wales Ltd* [1930] AC 720, Lord Russell, giving the opinion of the Privy Council, explained that a limited company not in liquidation can make no payment by way of return of capital to its shareholders except as a step in an authorised reduction of capital. Any other distribution of money, whether called dividend or bonus or any other name can only be made by way of division of profits. As the Judge observed, this is a clear statement that there are two categories of payment to shareholders – reduction of capital and dividend, or some other description, involving a distribution of profits. There is no third category mentioned; and it has not been suggested by anyone in the present case that there is some third category.

61. It is to be noted that the experts for HMRC did not substantively rely on any authorities, whether from Cayman Islands or England or elsewhere. In contrast, the experts for First Nationwide referred to a small number of Cayman authorities and to several English authorities, all of which were reviewed by the Judge. In answering the questions which they were asked to address, those experts were perfectly entitled to refer to these authorities; indeed, given the persuasive nature of English authorities – a fact which was common ground – it would have been surprising if they had not referred to relevant authorities. And, given the small number of reported Cayman cases, it is not surprising to find reference to cases which, although not directly in point, might give some indication of the thinking of the court. Ultimately, it was for the Judge to determine, as a matter of fact, what a Cayman court would be likely to say about the categorisation of the share premium account if the matter came before it.

62. Although foreign law is a question of fact, it is a "question of fact of a peculiar kind": see for instance *Parksha v Singh* [1968] P 233 at 250m, where the court considered it to be their duty to examine the evidence of foreign law which was before the justices in that case and to decide for themselves whether the evidence justifies the conclusion to which they came. That case was followed in *Dalmia Dairy Industries Ltd v National Bank of Pakistan* [1978] 2 Lloyd's Rep 233 where it was said that the appellate court must not "by uncritical acceptance of a trial

judge's conclusion of fact shirk its function of considering the evidence afresh and forming its own view of the cogency of the rival contentions". The position is usefully summarised in the judgment of the court in *MCC Proceeds Inc v Bishopsgate Investment Trust plc (No 4)* [1999] CLC 417 when addressing the court's approach to the findings of a trial judge about foreign law. They concluded that it all depended on the type of case. Some cases of foreign law may involve principles and concepts where the English judge's training and experience can make only a limited contribution to his decision. But

> "…. the foreign law may be written in the English language; its concepts may not be so different from English law. Then the English judge's knowledge of the common law and of the rules of statutory construction cannot be left out of account. He is entitled and indeed bound to bring that part of his qualifications to bear on the issue which he has to decide, notwithstanding that it is an issue of foreign law. There is a legal input from him, in addition to the judicial task of assessing the weight of the evidence given. The same applies, in our judgment, in the Court of Appeal. When and to the extent that the issue calls for the exercise of legal judgment, by reference to principles and legal concepts which are familiar to an English lawyer, then the court is as well placed as the trial judge to form its own independent view. [see paragraph 13]

63. In paragraphs 18 and 19, the court referred to and approved a passage from *Foreign Law in English Courts,* Richard Fentiman (1998), at p.202:

> "It should be noticed, however, that the Court of Appeal will confine itself to the task of assessing the evidence as it was presented to the Court below. Its task is to police errors by the trial judge, not to determine the question of foreign law *de novo*."

64. An appellate court should, in any case, be suitably circumspect about differing from the findings of a trial judge on questions of foreign law. It is one thing for an appellate court to review undisputed written material or undisputed agreed principles and then to see whether the judge has applied them correctly to the facts of the case. It is quite another for the appellate court to go behind findings of a judge who has heard oral evidence from expert witnesses and has seen their views tested in cross-examination.

65. Mr Gardiner points out that, in the present case, there was extensive written and oral testimony before the Judge from four witnesses. He submits, with more than

some justification, that the views advanced by the witnesses instructed by HMRC were highly speculative, and their evidence was contradicted by the witnesses instructed by First Nationwide, whose evidence was accepted by the Judge (and whose evidence he points out receives little if any consideration in Mr Gammie's written opening). The Judge, of course, heard the oral testimony of the witnesses subjected to extensive cross-examination. We agree when Mr Gardiner says that it is obvious that the court should at the very least be wary of interfering with the Judge's findings in these circumstances. In this context, it is worth quoting another passage from Mr Fentiman's book at pp.48–9:

> "This is not to deny that some cases are harder to resolve on appeal than others. The more a point turns upon radical differences of expert opinion, and the less it depends merely on the construction of documents, the harder an appellate court's task will be. More precisely, the possibility of serious review is less the more an appellate court must rely on the witness evidence of parties' experts. Indeed, it may in many cases be significantly harder to determine foreign law on appeal than at trial, where the judge may hear and see witnesses."

66. Mr Gammie invites us, in effect, to look at the question of Cayman law *de novo*. But there is this problem even if that approach is correct in principle. Albeit that a question of foreign law is a question of a peculiar kind, the answer to the question remains a finding of fact. Our statutory jurisdiction is restricted to appeals on a point of law. Accordingly, unless the Judge has made a finding about Cayman law (or, which comes to much the same thing, about what the Cayman court would be likely to decide) which he could not properly make on the evidence before him, there is no relevant error of law. It is one thing for the Court of Appeal on an appeal from the High Court to carry out the sort of reappraisal indicated in *Parksha* and *MCC Proceeds* in the exercise of the appellate jurisdiction which it possesses; it is another for us to do so in the context of a statutory right of appeal restricted to an error of law.

67. This is not, in the end, an issue which we need to resolve. This is because, for reasons which will become clear, we would have reached exactly the same conclusion as the Judge. So it makes no difference whether we say on the one hand that we are bound by the Judge's findings about Cayman law since there is

no error of (English) law sufficient to vitiate his conclusions, or on the other hand that on a review of the evidence of foreign law which was before the Judge and what the experts had to say we reach the same conclusions.

68. The Decision on this aspect of the case is, if we may say so, a model of clarity. We therefore propose to summarise what the Judge said, and then to address Mr Gammie's criticism and Mr Gardiner's submissions as to why Mr Gammie is mistaken.

69. The Judge first referred (in paragraphs 38 and 39) to two Cayman authorities (*Prospect Properties Limited (in liquidation) v. McNeill and J.M Bodden II* 1990-91 CILR 171 and *In re the Matter of Omni Securities Limited (No 5)* (2000) CILR 187) in arriving at his view that regard would be had to what is profit in the legal rather than the commercial sense. He preferred the opinion of the experts for First Nationwide on that point. He expressly stated that he did not consider that the court would be dissuaded from this view by the fact that the Cayman law refers separately in various places to "share premium" and "profits"; in the Judge's view, this did no more than recognise the fact that the share premium must be set aside in a separate account and did not provide any indication as to the legal nature of share premium.

70. He then considered a number of English and Commonwealth authorities and considered the extent to which they would be applied by the Cayman Islands court in considering the question in hand. They are: *Re Hoare & Co Ltd and Reduced* [1904] 2 Ch 208, *Re Bates* [1928] Ch 682, *Hill v Permanent Trustee, Re Spanish Prospecting Company* [1911] 1 Ch 92, *Re Duff's Settlement, Drown v Gaumont-British Picture Corporation Ltd* [1937] 2 All ER 609, and *Quayle Munro Ltd* [1992] SC 24 some of which we have already mentioned.

71. We do not propose to say anything about *Hoare* and *Bates* which are adequately summarised in paragraph 40 and 41 of the Decision. We agree with the Judge when he said, in relation to *Bates*, that the case was helpful in drawing the distinction (which we think must always be borne in mind) between what is in ordinary terms capital as distinct from income and what is capital for the purposes

of company law. We have already dealt with *Hill v Permanent Trustee.* We do not consider that *Spanish Prospecting Company* adds anything to what can be derived from *Hill v Permanent Trustee* and *Duff's Settlement*.

72. *Drown v Gaumont - British Picture Corporation Ltd* concerned distributions out of a reserve fund which had been built up to a large extent out of share premiums. It was held that that part of the reserve consisting of such premiums, unless set aside in some particular fund which had been spent, was available for dividend. The Judge described the decision as one that the Cayman court "would be likely to find most apt to the question of the nature of the share premium at issue in this case". After quoting a passage from the judgment of Clauson J at pp 616-7, the Judge said (and we agree) that it was

> "as clear a statement as there could be that share premium is different to share capital, and that the rules as to maintenance of share capital do not apply to share premium where it is not, by statute, assimilated to capital. The premium may be divided among shareholders in the same way as "normal profits"."

73. Mr Gardiner had submitted to the Judge that the principle set out so clearly in *Drown*, that if a premium is set aside by a company into a separate fund, it is nevertheless distributable profit and may be paid out by way of dividend, applied in the present case; the only difference between the situation in *Drown* and here being that the Cayman companies law provided a statutory rule that a share premium be set aside as a separate fund, rather than that being the result of a voluntary act of the company. The submission was that essentially the effect was the same. The Judge agreed that this was highly relevant to the question at issue and that a Cayman court would be likely to find it so. We agree with the Judge that it is highly relevant.

74. We have already considered *Duff's Settlement* in some detail in relation to what it has to say about the position prior to the Companies Act 1948. We have also stated the result of the decision to the effect that section 56 of that Act altered the position. The Judge set out the reasoning at paragraph 44 of the Decision. We think it is worth repeating here what Harman J said at pp 727-728:

> "A share in a company, as was pointed out for those interested in capital, has been described as "a bundle of rights", and one of those rights since the passing of the Act of 1948 has been to maintain the share premium account inviolable except to the extent to which it may be distributed by virtue of s. 56. It follows in my judgment that, when the share premium account is reduced in accordance with the section, there has been a reduction in the value of every share and it is therefore right to say that there has been a reduction of capital, though it is not share capital. The section has in fact produced a novel type of capital distributable only by the same process as any share capital and having, in my judgment, both in the hands of the company and in the hands of those who receive it as a result of a reduction petition, the quality of capital."

75. The change in the status of the share premium account from profit to capital was a result of section 56 and of section 56 alone. As the Judge observed, anything else, such as the creation of a separate reserve fund of the premium or voluntary restrictions on the ability to distribute out of premium, does not have this effect. Harman J also regarded the share premium account as representing a profit in the sense that the company obtained more than par value, but this was not a <u>distributable</u> profit: see the second passage quoted at paragraph 28 above.

76. Finally, the Judge referred to *Quayle Munro Ltd*. This concerned the cancellation of share premium. The Court there considered the common law position and concluded that, once the sums held at credit of the share premium account had been released from that account following the cancellation, they are available to be distributed in accordance with the principles described in *Drown* as profits distributable by way of dividend.

77. Now, it is always open to the legislature (whether in England or the Cayman Islands) to state that a particular fund may, or may not be, distributed in a certain way. Thus the Companies Act 1948 provided that a share premium account could only be distributed by way of a procedure appropriate to a reduction of capital with the consequence, as we have seen, that the share premium account could no longer be seen as profit available for distribution and was perhaps to be seen as more akin to capital than profit if one were to apply the conventional division between capital and profit. Equally, there is no reason in principle why exactly the reverse should not occur. It is within the power of Parliament to abrogate the requirement for a distribution out of share premium account to be effected by a

capital reduction. If that were done, there can be no doubt in the light of the authorities which the Judge discussed in some detail and which we have considered more briefly, that the share premium account of an English company would once again be seen as representing profit rather than capital.

78. The Judge then addressed the views expressed by the experts, and in particular those expressed by the experts for HMRC, and stated his own conclusions in paragraphs 46 to 48 of the Decision. It was, as we have said, common ground that English and Commonwealth authorities were persuasive in the Cayman courts. But the view of HMRC's experts was that the pre-1948 position under English law would not be determinative of the position under the law of the Cayman Islands after the enactment of the Cayman Islands Company Law 1989. Mr Scrivener (one of HMRC's experts), noted that s 34 of the Companies Law (2003 Revision) (the section dealing with the share premium account) appeared in a part of the Law that included reference to distributions of capital and therefore regarded the English authorities as being not particularly helpful in interpreting section 34. He considered the enactment of the 1961 Companies Law (in particular, section 32) as the starting point for Cayman company law in identifying share premium. His view was that the English cases do not have a bearing on that matter because the Cayman regime was different from the English regime at that point of time. By contrast, the experts for First Nationwide took the view that the English authorities were not only relevant, but that those authorities would be followed by a Cayman court.

79. The Judge concluded, in paragraph 47 of the Decision, that the Cayman courts would be prepared to give effect to the principles of English law as a matter of Cayman law. Section 32 of the 1961 Law was modelled closely on section 56 of the English Companies Act 1948, and was to be regarded as having the same statutory effect. The removal of the assimilation to capital in 1989 was, in his view, to be regarded as having a similar outcome to the removal of share premium from those corresponding restrictions under the English law provisions as in *Quayle Munro*, namely to render share premium once more as profit distributable by way of dividend.

80. The Judge was not persuaded, and did not believe that a Cayman court would be, that Cayman company law is a wholly discrete regime, and that in consequence the English and Commonwealth authorities would be regarded by a Cayman court as having no application. He did not consider the fact that section 34 of the Companies Law (2003 Revision) requires an amount to be transferred to share premium account as affecting, or altering, the legal nature of that share premium. Nor did he consider that the solvency test (to which we have referred) altered in any way the nature of the share premium account, namely as representing profit. He considered that the character of share premium could be transmuted from its normal character of profit into that of capital, or some special intermediate category of distributable share premium distinct from profit, only by express provision such as the assimilation of share premium account to share capital under s 56 of the English Companies Act 1948 or s 32 of the Cayman Islands Company Law 1961. Once section 32 had been superseded by the 1989 Law, and the statutory assimilation had disappeared, he concluded that the view of the experts for First Nationwide was the correct one, and that a Cayman court would determine that the share premium reverted to distributable profit.

81. Mr Gammie says that the Judge erred in that conclusion when Cayman law "explicitly distinguishes between share premium and profits in several fundamental ways". He identifies these differences:

   a. The distribution of share premium is subject to a specific "cash flow" solvency rule.

   b. The payment of dividends in breach of the solvency test is subject to criminal penalty.

   c. Cayman law distinguishes share premium account from profits by requiring it to be segregated in a separate account. The statutory provisions also refer to share premium and profits separately on several occasions.

82. We have already addressed the solvency test sufficiently in paragraphs 56*ff* to 59 above. We do not consider that this difference takes the issue any further.

83. As to the penalty, the Judge was aware of the existence of the penalty as is clear from paragraph 36 of the Decision. The Judge did not address this distinction separately. It had really featured only as an aspect of the argument about the nature of the insolvency test and its difference, if any, from the common law rules about when dividends could properly be paid. One of the experts for HMRC (Mr Scrivener) did address the criminal penalties but even he did so in the course of his discussion of the insolvency test. He drew the distinction between payments of dividends out of share premium account where the company was unable to pay its debts as they fell due and where a criminal penalty could be imposed and payments of dividends out of profits (he would need to add "other" before "profits" if the Judge was right in saying that share premium account is to be regarded as profit) where there can be no such penalty. He then said this:

> "The fact that the Cayman Legislature felt it necessary to introduce such criminal sanctions in the case of a dividend paid out of the share premium account suggests that it recognised the additional creditor protection necessary in connection with the payment of dividends out of the share premium account and therefore appeared to regard share premium more akin to share capital than profits."

84. We simply do not understand why the conclusion ("therefore….") follows the premise. We consider that the premise is, in any case, entirely neutral. Once one puts aside the possible difference between the common law rule and the statutory insolvency test for the making of distributions, one is left simply with criminal sanctions designed to protect creditors as Mr Scrivener observes. So there are different funds – share premium account and other distributable accounts – out of which dividends can be paid; payment out of one results in criminal sanctions where the solvency test is not satisfied; payment out of the other does not do so. That fact does not seem to us to make any difference to the categorisation of those different funds. If it is a relevant factor at all, it is of very little weight in our view. Of far more importance is the fact that the distribution which can be made when the solvency test is satisfied is called a dividend, is paid from a fund which is divisible between shareholders and is paid out in accordance with a mechanism

(a dividend payment) appropriate to payment out of funds (for example trading profits) which even the experts for HMRC would regard as profit.

85. As to the third difference relied on, we do not consider that the mere fact of the separation of the share premium into a separate account taken by itself would result in the share premium account being regarded as capital rather than profit. Such a result would be inconsistent with the entire thrust of the authorities addressed by the Judge and by us. The references in other places to “share premiums” or “share premium account” and “profits” or “profit and loss account” are, we agree with the Judge, no more than a reflection of the fact that share premium has to be carried to a separate account and of the different balance sheet categories of those accounts.

86. We have so far addressed each of Mr Gammie’s three differences separately and conclude that no one difference would lead to the conclusion that the share premium account was capital rather than profit available for distribution. Further, taking all of them together, we do not consider that their cumulative effect results in a different conclusion. They are simply inadequate to transform what is ordinarily profit – that is to say a share premium – into capital. We reach that conclusion even if the experts for HMRC are correct to say that the starting point is the 1961 Cayman Islands Company Law. We do so, as did the Judge, by reference to the English authorities and *Quayle v Monroe*.

87. In our judgment, the share premium account is properly categorised as profit in contrast with capital under Cayman law even if we are wrong in our principal reasons for concluding that the Preference Dividends were “dividends” within the manufactured payments provisions.

Issue 2: overseas dividends or not?

88. It is common ground that to fall within the definition of “overseas dividends”, the Preference Dividends must be income dividends chargeable under Case V Schedule D. Mr Gardiner says that plainly they were. Mr Gammie says that, equally plainly, they were not. In making that submission Mr Gammie suggests that the Judge compounded his errors on the dividend issue. We can see that if the

Judge was (contrary to our view) wrong on the first issue, what he had to say about overseas dividends might be open to criticism. But if, as we have held, he was right on the first issue for the reasons given by the Judge and upheld by us, it is not entirely easy to see where the Judge can fairly be criticised.

89. As before, we find it helpful to address what the Judge said. In paragraph 51, he noted perfectly correctly that it was necessary to determine the true nature of the foreign possession (the First and Second Issued Preference Shares) and the effect of the distribution (the Preference Dividends) on the corpus of the foreign possession. He put his earlier conclusion on the capital versus profit debate in a different way. Instead of describing the share premium account as profit, he expressed his view that the capital of Blueborder, as a matter of Cayman law, comprised only the nominal share capital of the First and Second Issued Preference Shares (together with, of course, the nominal share capital of the Ordinary Shares) and not the share premium . Accordingly, the key question in determining the nature of the Preference Dividends for this purpose was the consequence of those dividends on the corpus of the First and Second Issued Preference Shares.

90. The Judge referred in detail to *Reid's Trustees* and *Rae v Lazard*. We, too, need to refer to the latter in some detail. The taxpayer was an English company. It purchased as an investment shares in a Maryland company, Certain-teed. Certain-teed had two manufacturing businesses – asphalt roof products and gypsum and paper products. The board decided to hive-off the gypsum and paper product business. It did so by a procedure authorised by the law of Maryland (with no counterpart – at least at that time – under English law) known as distribution in partial liquidation. A new company, Bestwall, was formed for the purpose. The consideration for the business was shares in Bestwall which were distributed to the shareholders in Certain-teed. The hived-off business was considerably more valuable than the business retained by Certain-teed. The taxpayer was assessed to income tax on the basis that the shares in Bestwall which it received were income within Case V of Schedule D. The Special Commissioners discharged the assessment on the grounds of the facts found by them:

a. under Maryland law it would not have been possible to effect this "hive-off" by way of declaration of dividend;

b. under Maryland law the taxpayer's original interest in Certain-teed did not remain intact, and the courts of Maryland would look at the substance of the transaction which was that the taxpayer's original interest was in the entirety of Certain-teed's capital assets and that their subsequent interest was comprised in their combined holdings of stock in Certain-teed and Bestwall, and that those two holdings represented the identical assets in which they had their original interest; and

c. under the law of Maryland the taxpayer did not receive a dividend from Certain-teed but received capital.

91. In the House of Lords, it was held that it is not the source from which the assets are distributed by a company but the machinery employed in their distribution which determines whether they are received by a shareholder as capital or income; that in ascertaining the character of a payment to a shareholder by a corporation incorporated under Maryland law resort must be had to the legal machinery employed by the company under Maryland law; and that, since, as a matter of fact, by the law of Maryland the Maryland corporation had made a distribution of capital which was received as such in the hands of the shareholder, it was not subject to United Kingdom income tax. On the question whether a receipt is capital or income, Lord Reid said this (at p 567):

> "In deciding whether a shareholder receives a distribution as capital or income our law goes by the form in which the distribution is made rather than by the substance of the transaction. Capital in the hands of the company becomes income in the hands of the shareholders if distributed as a dividend, while accumulated income in the hands of the company becomes capital in the hands of the shareholders if distributed in a liquidation. In the present case the form of the distribution was one unknown to our law — distribution in a partial liquidation. By the law of Maryland which governs the company and which authorised this distribution the shares distributed were capital in the hands of the shareholders. Why, then, should we regard them as income? It is said that if this had been an English company and it had done what Certain-teed did these shares would have been income in the hands of the shareholders. But an English company could not do what Certain-teed did for it could not distribute

> in a partial liquidation. No doubt an English company could have reached the same result by using a different method — declaring a dividend. But it is found as a fact that it would not have been possible in Maryland to effect this transaction by way of a declaration of dividend. So why are we to hold something to be a dividend which by the law of Maryland was not and could not be a dividend? There is no question here of the foreign law producing a result which is unreasonable or contrary to our idea of justice."

92. The same approach (with a different result) can be adopted in relation to a dividend from the share premium account of a Cayman company. Such dividends would be effected pursuant to a mechanism which was (i) essentially the same mechanism as would apply to an ordinary dividend declared out of trading profits and (ii) essentially the same as would apply to a distribution by way of dividend by an English company. Given our view that the share premium account is profit rather than capital, we consider the result to be that, in English law, the dividend will be received as income. This is the case, in our view, even if Cayman law would treat the receipt as capital in the hands of the recipient. English law judges the nature of the receipt by reference to the mechanism provided by the foreign law. In a case such as *Rae v Lazard* where the mechanism of distribution was unknown to English law, there was no reason to depart from the categorisation of the receipt under Maryland law. But where the fund out of which the distribution is made is profit and where the mechanism employed for its distribution is that applicable to dividends generally, we do not consider that the treatment of the dividend as an income or capital receipt under Cayman law is determinative.

93. We find some support for that in the decision of Pennycuick J in *Inchyra (Baron) v Jennings* [1966] Ch 37; the judge considered a number of authorities including *Rae v Lazard* which he clearly did not see as requiring him to adopt the relevant foreign categorisation as conclusive of the English income treatment. In that case, the judge decided the matter on the basis that the classification of a receipt from a trust as capital or income for the purposes of English law was to be decided in the light of the rights which the recipient has and the machinery by which he obtained the distribution and not by the classification of the receipt according to the foreign law.

94. We consider, in any case, the issue of whether the share premium account is profit or capital to be beside the point. It comes back to the exclusive categorisation point that all accounts out of which distributions can be made must be either profit or capital. If a dividend can be paid out of a particular fund, then it is properly to be categorised as "profit" in that context. We bear in mind the following passage from *Verner* v *General and Commerical Investment Trust* [1894] 2 Ch 239, at 266:

> "It has been already said that dividends presuppose profits of some sort, and this is unquestionably true. But the word "profits" is by no means free from ambiguity. The law is much more accurately expressed by saying that dividends cannot be paid out of capital, than by saying that they can only be paid out of profits."

95. We therefore consider that dividends paid out of the share premium account of a Cayman company are ordinarily to be seen as payments of income (and received in the hands of the shareholder as income) for English law purposes. We say "ordinarily" because there may be special features of a particular class of share leading to the conclusion that a premium paid on those shares is capital of the company in the same way as nominal share capital. Whether that is so in relation to the First and Second Issued Preference Shares is, in our view, the same question, put in a different way, as whether the Preference Dividends left those shares intact or not, the question we turn to in a moment.

96. In the paragraphs following that just cited from *Rae v Lazard*, Lord Reid referred to passages from the speeches in *Reid's Trustees* about the test for deciding whether receipts from foreign possession are income or capital. One finds variously "whether the corpus of the asset remains intact in the hands of the taxpayer" (Lord Simonds), "The shares of the company remained after the distribution intact and precisely as they were before it" (Lord Normand) and "No doubt the shares abated in market value after the payment of the dividend, but they nevertheless remained intact. The ripe tree loses weight and worth when it sheds its fruit, but the fruit remains fruit and no more unless in its fall it has taken part of the tree with it." (Lord MacDermot).

97. Lord Reid accepted that test without reservation; for him the question was whether "the corpus of the asset" or "the shares of the company" or "the capital of the possession" did or did not remain intact after the Bestwall shares were distributed: or whether the Bestwall shares were merely fruit or had in their fall taken part of the tree with them. And that question was to be answered by reference to the law of Maryland.

98. The Judge referred to the relevant passage, and then turned to *Courtaulds Investments Ltd v Fleming* 46 TC 111 which we have not yet mentioned. We should say a little about it since it is relied on by HMRC. It concerned an Italian company, whose directors in their annual report proposed making a number of distributions to members. However, the Italian Government had instituted a new tax on dividends called the *imposta cedolare*. The company, instead of declaring a dividend, made a distribution from its *riserva sovraprezzo azione* (which was a reserve equivalent to share premium account in English law, payment out of which constituted a return of capital under Italian law). The question for the Court was whether the distribution was, in the UK taxpayer's hands, income arising from a foreign possession within the meaning of Case V of Schedule D.

99. Buckley J explained that the nature of the foreign possession and the effect of the distribution upon it should be ascertained by reference to the foreign law. The Special Commissioners had held that a return to shareholders from the *riserva sovraprezzo azione* was a return of capital under Italian law. Buckley J, having explained that the nature of a possession, and the effect of a distribution on it, can only be ascertained by reference to the law which governs it, held that, on the Special Commissioners' findings, the position was similar to that under English post-1948 company law in treating premiums paid on shares as being, *ab initio* and always, notional paid-up capital of the company. Consequently, the foreign possession was not left intact and the distribution was a return of capital. As he put it, the effect of the distribution out of the Italian share premium reserve was to "lop from the tree part of the engrafted member consisting of the share premium reserve", and the dividends did not leave the shares "intact".

100. Mr Gammie submits that if the metaphor of fruit and tree is similarly adopted in the present case, then the First and Second Preference Dividends took away virtually the whole of the tree (about 98%), leaving almost nothing behind. But Mr Gardiner says that the case provides no support for HMRC's position: by contrast with the nature of the *riserva sovraprezzo azione*, the share premium here was not assimilated to capital and its distribution by way of dividend had no effect on the capital. It was simply a distribution of cash by dividend in the ordinary manner.

101. We do not consider that *Courtaulds* adds anything to the debate. It restated established principles and on its facts is entirely distinguishable for the reasons Mr Gardiner mentions. In any case, as with all analogies or metaphors, reference to fruit and trees does not give a clear answer unless you describe the fruit and the tree. It is common to call the banana plant a tree. But after producing a bunch of bananas, the stem dies. The banana remains the fruit, but part of the tree has gone with it.

102. In any case, the analogy is that the fruit (the Preference Dividends) have taken away 98% of the tree (the First and Second Issued Preference Shares). What the Preference Dividends have done is to reduce the value of the company. That could be true, as Mr Gammie accepts, of any dividend, for instance in the case of a company with very large profits available for distribution, say, arising as the result of a sale of land which has substantially increased in value. The distribution of such profits could reduce the value of the company by a very large percentage, but that would not represent a change in its corpus. That, however, is not the point which Mr Gammie makes.

103. The relevant point, according to him, is that because of the unusual structure of the rights attaching to the First Issued Preference Shares (he says that they were designed specifically for the purpose of the tax-structured financing transaction entered into between ABN AMRO and First Nationwide but that is not relevant in our view), the Preference Dividends had the effect of taking away 99.99% of those Shares' future rights to dividends and 98% of their future rights to return of capital. This effect was, moreover, permanent. That is, even if Blueborder had

subsequently commenced a real business and become hugely profitable, the holder(s) of the First Issued Preference Shares – once the First and Second Preference Dividends had been paid in December 2003 and March 2004, and had those Shares remained in existence – would only have been entitled to the payment of annual dividends of 1% pa of the paid-up nominal amount of £1 per share, and to the payment of £19.98 per share plus an interest-based increment at 1% per annum on a future return of capital (as contrasted with the entitlement to £1,022.8459 per share in the event of a return of capital ***before*** the First and Second Preference Dividends were paid).

104. That is all no doubt correct. But it does not lead to the conclusion for which Mr Gammie contends. The suggestion appears to be that because distributions could be made by way of capital on a winding-up, the true nature of the share premium account is to be seen as capital; so that when it ceases to be available on a winding-up because it has been distributed as dividend, there must therefore have been a change in the corpus of the estate. That seems to us be something of a bootstraps argument. There is no reason to treat a dividend as bringing about a change in the corpus of the estate (to establish it is capital) just because, were the same amount to be distributed on a winding-up, such amount would be capital. In a reverse situation, it is clear (for instance for trust purposes) that the accumulation of profits in a company and the issue of bonus shares on the capitalisation of those profits gives rise to capital in the hands of the recipient, notwithstanding that those profits could have been distributed as dividend and thus received as income.

105. Nor do we see any support for the result contended for by reference to the hypothetical successful business. The Preference Shares were not entitled to share in the trading profits of the company beyond a limited extent following payment of the First and Second Preference Dividends: trading profits were available for distribution to the holders of the Ordinary Shares.

106. The Judge was well aware of the relevant rights attaching to the First and Second Issued Preference Shares: he described them, by reference to Mr Gammie's skeleton argument, in paragraph 58 of the Decision. Then, after

summarising Mr Gammie's arguments on behalf of HMRC (see paragraph 59) he expressed his own views at paragraph 60 and 61. Since we agree entirely with what the Judge said, we set out those paragraphs:

> "60……In my view the proper analysis of the Cayman law is that the corpus of the assets in question is the nominal share capital only of the First and Second Issued Preference Shares. Unlike the position in *Courtaulds Investments*, there is no legal reserve in Cayman law with which to equate share premium reserve, nor in my view is the distribution under Cayman law a distribution of capital. Whereas in *Courtaulds Investments* it was not correct to assimilate the position of the Italian company to that under English law prior to 1948, this was on the basis that it had been found that under Italian law the distribution from share premium reserve was a distribution of capital. There is no such finding here. Indeed, I have found the opposite to be the case; share premium account under Cayman law is not in my view capital, but is distributable profit. It follows that I consider that a dividend out of Blueborder's share premium account ought properly to be assimilated to such a dividend under English law pre-1948. Such a dividend would not be a return of capital, but would be a distribution of profits.
>
> 61. Mr Gammie's argument rested on the corpus of the foreign possession being not only the nominal value of the First and Second Issued Preference Shares but the amounts specified in the articles of association as the "priority capital repayment amounts". He relied upon this to demonstrate that the effect of the payment of the Preference Dividends was to reduce the rights to "capital" under the articles, and not simply the value of the shares, by 98%. He compared this to the lopping from the tree of part of the engrafted share premium reserve as in *Courtaulds Investments*. I do not consider this is right. The first point is that, unlike in *Courtaulds Investments*, there is no engrafting of the share premium account onto the First and Second Issued Preference Shares. Share premium account under Cayman law was not, at the material time, assimilated to share capital, but was, as I have found, part of the distributable profit. Secondly, in my view the dividend rights in this case were part of the fruit and not part of the tree. Dividend rights that are satisfied otherwise than out of share capital, or a reserve that is assimilated to share capital, are part of the fruit even though they may be exhausted by the payment of a dividend. Such a dividend is the fruit even though it might be harvested in a single crop.

107. Agreeing as we do, it follows in our judgment that the Preference Dividends did constitute income chargeable under Case V of Schedule D and that accordingly they were "overseas dividends" for the purposes of the manufactured payments provisions.

Sections 737A and 730A

108. In the light of our decision so far, it is necessary to consider whether or not the transactions entered into between First Nationwide, Anglo Irish Bank and Blueborder amounted to a sale and repurchase of securities for the purposes of sections 737A and 730A of ICTA. In this context the question more particularly stated is whether First Nationwide's subscription for the Second Issued Preference Shares amounted to "buying similar securities" (similar, that is, to the First Issued Preference Shares which First Nationwide had sold to Anglo Irish Bank) – it will be recalled that First Nationwide needed to acquire the Second Issued Preference Shares in order to satisfy its obligations under its stock lending agreement with ABN AMRO to re-deliver securities (Preference Shares in Blueborder) corresponding to the First Issued Preference Shares it had acquired by that agreement. If First Nationwide's subscription amounted to "buying similar securities", the effect is, as the Judge put it, that the "relevant person" as defined under s 737A(6) (which would in these circumstances be Blueborder) is deemed by virtue of s 737A(5) to have paid to First Nationwide an amount representative of the relevant dividend, which then falls to be treated under Schedule 23A as the receipt of a manufactured overseas dividend on which First Nationwide would be liable to tax under paragraph 4(4) of Schedule 23A.

109. The statutory provisions are set out in full in paragraphs 67 to 70 of the Decision. The critical provisions are sections 737A(1), together with 737B(5) and section 730A(1) together with section 730B(2)(a). However, it is necessary to view these provisions as a whole in order to understand the submissions made. We therefore set them out again:

"**737A Sale and repurchase of securities: deemed manufactured payments**

(1) This section applies where on or after the appointed day a person (the transferor) agrees to sell any securities, and the transferor or a person connected with him—

> (*a*) is required to buy them back in pursuance of an obligation imposed by, or in consequence of the exercise of an option acquired under, that agreement or any related agreement, or
>
> (*b*) acquires an option to buy them back under that agreement or any related agreement which he subsequently exercises;

but this section does not apply unless either the conditions set out in subsection (2) below or the conditions set out in subsection (2A) below are fulfilled.

(2) The first set of conditions referred to in subsection (1) above are that—

(*a*) as a result of the transaction, a dividend which becomes payable in respect of the securities is receivable otherwise than by the transferor,

(*b*) ...

(*c*) there is no requirement under any agreement mentioned in subsection (1) above for a person to pay to the transferor on or before the relevant date an amount representative of the dividend, and

(*d*) it is reasonable to assume that, in arriving at the repurchase price of the securities, account was taken of the fact that the dividend is receivable otherwise than by the transferor.

(2A) The second set of conditions referred to in subsection (1) above are that—

(*a*) a dividend which becomes payable in respect of the securities is receivable otherwise than by the transferor,

(*b*) the transferor or a person connected with him is required under any agreement mentioned in subsection (1) above to make a payment representative of the dividend,

(*c*) there is no requirement under any such agreement for a person to pay to the transferor on or before the relevant date an amount representative of the dividend, and

(*d*) it is reasonable to assume that, in arriving at the repurchase price of the securities, account is taken of the circumstances referred to in paragraphs (*a*) to (*c*).

(3) For the purposes of subsections (2) and (2A) above the relevant date is the date when the repurchase price of the securities becomes due.

(4) Where it is a person connected with the transferor who is required to buy back the securities, or who acquires the option to buy them back, references in the following provisions of this section to the transferor shall be construed as references to the connected person.

(5) Where this section applies, ... Schedule 23A and dividend manufacturing regulations shall apply as if—

(*a*) the relevant person were required, under the arrangements for the transfer of the securities, to pay to the transferor an amount representative of the dividend mentioned in subsection (2)(*a*) or (2A)(*a*) above,

(*b*) a payment were made by that person to the transferor in discharge of that requirement, and

(*c*) the payment were made on the date when the repurchase price of the securities becomes due.

(6) In subsection (5) above “the relevant person” means—

(*a*) where subsection (1)(*a*) above applies, the person from whom the transferor is required to buy back the securities;

(*b*) where subsection (1)(*b*) above applies, the person from whom the transferor has the right to buy back the securities;

and in that subsection "dividend manufacturing regulations" means regulations under Schedule 23A (whenever made)."

"**737B Interpretation of section 737A**

(1) In section 737A and this section "securities" means United Kingdom equities, United Kingdom securities or overseas securities; and—

(*a*) where the securities mentioned in section 737A(1) are United Kingdom securities, references in section 737A to a dividend shall be construed as references to a periodical payment of interest;

(*b*) where the securities mentioned in section 737A(1) are overseas securities, references in section 737A to a dividend shall be construed as references to an overseas dividend.

(2) In this section "United Kingdom equities", "United Kingdom securities", "overseas securities" and "overseas dividend" have the meanings given by paragraph 1(1) of Schedule 23A.

(3) For the purposes of section 737A agreements are related if each is entered into in pursuance of the same arrangement (regardless of the date on which either agreement is entered into).

(4) In section 737A "the repurchase price of the securities" means—

(*a*) where subsection (1)(*a*) of that section applies, the amount which, under any agreement mentioned in section 737A(1), the transferor or connected person is required to pay for the securities bought back, or

(*b*) where subsection (1)(*b*) of that section applies, the amount which under any such agreement the transferor or connected person is required, if he exercises the option, to pay for the securities bought back.

(5) In section 737A and subsection (4) above references to buying back securities include references to buying similar securities.

(6) For the purposes of subsection (5) above securities are similar if they entitle their holders to the same rights against the same persons as to capital and interest and the same remedies for the enforcement of those rights, notwithstanding any difference in the total nominal amounts of the respective securities or in the form in which they are held or the manner in which they can be transferred; and "interest" here includes dividends.

(7) For the purposes of section 737A and subsection (4) above—

(*a*) a person who is connected with the transferor and is required to buy securities sold by the transferor shall be treated as being required to buy the securities back notwithstanding that it was not he who sold them, and

(*b*) a person who is connected with the transferor and acquires an option to buy securities sold by the transferor shall be treated as acquiring an option to buy the securities back notwithstanding that it was not he who sold them.

(8) Section 839 shall apply for the purposes of section 737A and this section.

(9) In section 737A "the appointed day" means such day as the Treasury may by order appoint, and different days may be appointed in relation to—

(*a*) United Kingdom equities,

(*b*) United Kingdom securities, and

(*c*) overseas securities."

"**730A Treatment of price differential on sale and repurchase of securities**

(1) Subject to subsection (8) below, this section applies where—

(*a*) a person ("the original owner") has transferred any securities to another person ("the interim holder") under an agreement to sell them;

(*b*) the original owner or a person connected with him—

(i) is required to buy them back in pursuance of an obligation imposed by, or in consequence of the exercise of an option acquired under, that agreement or any related agreement, or

(ii) acquires an option to buy them back under that agreement or any related agreement which he subsequently exercises; and

(*c*) the sale price and the repurchase price are different."

"**730B Interpretation of section 730A**

(1) For the purposes of section 730A agreements are related if they are entered into in pursuance of the same arrangement (regardless of the date on which either agreement is entered into).

(2) References in section 730A to buying back securities—

(*a*) shall include references to buying similar securities; and

(*b*) in relation to a person connected with the original owner, shall include references to buying securities sold by the original owner or similar securities,

notwithstanding (in each case) that the securities bought have not previously been held by the purchaser; and references in that section to repurchase or to a repurchaser shall be construed accordingly."

110. Since the statute includes deeming provisions, we have in mind the principles established in *Marshall (Inspector of Taxes) v Kerr* 67 TC 56 (see at 79), *Jenks v Dickinson* [1997] STC 853 at 878 and *DCC Holdings (UK) Ltd v HMRC* [2011] 1 WLR 44. As Mr Gammie urges us, we therefore recognise the difficulties in statutory deeming provisions spelling out the precise limits of the circumstances in which the artificial assumptions are to apply; and are careful to interpret the provisions so as to avoid injustice or absurdity in their application.

111. There is no dispute that the Second Issued Preference Shares were "similar" securities for the purposes of sections 737A(5) and 730B(2); they were without doubt similar to the First Issued Preference Shares. The issue is whether the <u>subscription</u> for the Second Preference Shares falls within the meaning of "buying" in those subsections or whether it is necessary for shares to be in existence before they can be bought in this context.

112. HMRC's position is that First Nationwide's subscription for the Second Issued Preference Shares did constitute "buying". "Buy" it is said is an ordinary word of no technical meaning and "buying similar securities" thus encompasses purchase of shares by way of subscription (*ie*. a transaction comprising the issue of shares in consideration for cash subscribed for those shares), as well as a purchase by way of transfer of existing shares in consideration for the payment of cash to the holder of those shares.

113. The Judge concluded that the normal meaning of "purchase" or "buying" in relation to shares or securities of a company (whether a company incorporated under English law or under foreign law) excluded a subscription, unless the context indicated otherwise. There was no such contextual indication in sections 737A or 730A.

114. Mr Gardiner had argued that it was apparent from the wording of the sections that there must be a sale and repurchase (or a sale and a further purchase). Each section required there to be an agreement to sell the securities and to buy them back (or to buy similar securities). The sections also used terminology such as "repurchase price", "repurchaser", "transfer" and "transferor", and they are

headed “Sale and repurchase of securities”. He submitted that these are some of the most closely articulated and detailed provisions in the tax legislation, and that in a case where the legislation creates a legal fiction, precision in the draftsman’s language must be particularly respected.

115. The Judge agreed with Mr Gardiner that if Parliament had wished to extend the ambit of those sections to transactions involving a subscription for shares, special provision would have to have been made to this effect.

116. Mr Gammie in his argument before us set the scene by reference to the facts. He described briefly the nature of a repo (which as far as it goes is unexceptional): a repo is a transaction whereby a company raises funds by transferring securities for a price and subsequently purchases back from the counterparty the same or similar securities for a price, thereby repaying the funds (the substantive economic effect of the transaction being that of a loan and the function of the transferred securities being similar to that of the security given in the case of a secured lending). After describing the essence of the transactions in the present case, he set out HMRC’s contention that the transaction comprised a stock loan (from ABN AMRO to First Nationwide) followed by a repo (being a three-party repo under which the original shares were transferred by First Nationwide to Anglo Irish Bank but the similar shares were acquired by First Nationwide from Blueborder itself).

117. This result, he argued, meets the conditions for symmetry which was central to the decision in *DCC*. First Nationwide has entered into a stock loan with ABN AMRO under which it pays manufactured overseas dividends. By the same token it should be deemed to receive manufactured overseas dividends of the same amount under the repo with Anglo Irish Bank. The result of setting the payments against the deemed receipts enables the economic symmetry between the stock loan and the repo to be followed for tax purposes.

118. We are very cautious indeed in approaching the question of construction on the basis of the facts of a particular case. Even if we accept the contention that the transaction in the present case is of the same economic effect as a conventional

repo, it has included a step which is not part of a conventional repo as described by Mr Gammie. If we decide that "buying" includes the subscription for shares, that will be so in all cases of subscription. We simply have no idea what the wider consequences of such a decision might be in a major market which operates within a very detailed and carefully prescribed tax regime.

119. But it is the case, we think, that it cannot be said to be obvious that transactions involving subscriptions ought to fall within the repo legislation as if they were purchases. We say that because of what HMRC themselves have said. Mr Gardiner has referred us to HMRC's own Technical Note: Possible New Repo Legislation for Companies (19 January 2007). This paper asked for comments on proposed new legislation from those familiar with the operation of these markets, and included the following question: "The rules as drafted apply only to sales of securities. Other tax jurisdictions recognise a repo as including… the case where the initial acquisition of securities is by way of their issue by a company directly to the "lender". Is it considered desirable to extend the definition of repo to include these – for instance by deeming cases where there is a sale or purchase of securities to include cases where they are issued or subscribed for?"

120. Now, we do not take judicial notice of (and there is no evidence about) what parties in the market were aware of. But we do note what HMRC said in their Technical Notes. The Technical Notes are not, of course, determinative of the law and may not even be admissible when it comes to the true construction of the legislation. But they are relevant and admissible to demonstrate that HMRC at least thought that there was a need to seek views about whether subscriptions should also be covered. If they had thought that the answer was obvious and that the omission to include them already was an oversight, the Technical Notes would have been in a very different form.

121. Nor are we influenced by arguments based on economic symmetry. They seem to us to be (a) irrelevant and (b) incomplete in that they do not meet the point that in First Nationwide's case the First Issued Preference Shares gave rise to a chargeable gain of some £49 million (the fact that losses arising elsewhere within the Society's group were set against this gain is not relevant).

122. So we must start (as, to be fair to him, Mr Gammie started) with the ordinary meaning of the words “buying similar securities” which in turn depends almost entirely on the ordinary meaning of the word “buy”. The difficulty with this approach, however, is that there is no single ordinary meaning of the word “buy”: it has different ordinary meanings and the actual meaning is dictated by the context. Mr Gammie referred us to the definition in the Concise Oxford Dictionary (1982 edition) as “obtain in exchange for money”. But, of course it is implicit in that definition that <u>something</u> is obtained and whether the compiler of the dictionary had thought about the acquisition of something which did not already exist is mere speculation. In any case, the definition is too wide if read literally. If a person hires a car for a weekend, he obtains it (in the sense of obtaining possession of it) in exchange for money but he certainly does not buy it.

123. We accept that “buy” can in some circumstances include the acquisition of something which does not already exist. A person might acquire a long leasehold interest in a property: he might do so by acquiring an existing lease from an existing lessee, or he might do so by taking a new grant as the original tenant. It would be a perfectly proper use of language for him to say that he had bought a lease of the property in either case, although he might more usually say simply to his friends “I’ve just bought a property in Wonderland - only a lease of course”.

124. The authorities provide examples of a wide meaning being given to the purchase and sale. Mr Gammie referred to *Re Turcan* LR 40 Ch D 5 where “purchase” had been held to cover the transaction whereby a life insurance policy (that is, a newly created chose in action) was acquired, to *Mersey Docks & Harbour Board v IRC* [1897] 2 QB 316 at p 317 where in the context of stamp duty the payment for the grant of an annuity was a purchase of the annuity and to *Wimpey v IRC* [1975] 1 WLR 995, where, again for stamp duty purposes, the grant of an option was held to be a sale and purchase of the option.

125. We do not think that Mr Gammie would disagree that the context is critical. But, starting with a wide ordinary meaning, he says there is nothing in ICTA which undermines or restricts such an ordinary meaning. His complaint is that the

Judge held the "normal meaning" of the words 'buy' and 'purchase' excludes purchase by subscription "unless the context indicates otherwise". This he submitted was the wrong approach; rather, the ordinary meaning of the words plainly includes purchase by way of subscription and a narrow interpretation can only be justified if the context indicates that it should be excluded. There is nothing in the context of ICTA to indicate the exclusion of purchase by subscription; in fact, the drafting of the provisions clearly indicates that it was intended to be included.

126. In any case, he said that the overall intention behind sections 737A and 730A is that they are to apply where the transferor (or a connected person) transfers shares under an agreement for sale and, under a related agreement, he or a connected person is to (or has an option to) get back the same or equivalent securities. In the light of this purpose, the mechanism by which the transferor gets back the same or equivalent securities is not critical, nor even material. This, it seems to us, is to assume the answer which he wants: by identifying the intention of the legislation in that particular way, one is almost inevitably led to the conclusion which brings within its ambit any transaction which is subsumed within that intention (provided of course than it can reasonably be called a purchase – or "buying" – within a wide understanding of the concept).

127. So, rather than striving to find an overly restrictive meaning of the word "buy", the Judge should have adopted the ordinary, usual meaning of the word to ensure that the purpose of these provisions (taxing every type of repo transaction uniformly and in line with its economic substance) was given effect to. Thus, according to Mr Gammie, the words "buying similar securities" in sections 737B(5) and 730B(2) are quite capable of including a purchase by way of subscription, and nothing in the legislation suggests a narrower interpretation. Had the Judge approached this matter of construction in the correct manner he would have reached this conclusion.

128. The main authority relied on by Mr Gardiner on this aspect of the case was *Re VGM Holdings Ltd* [1942] 1 Ch 235. This case concerned the provision of the Companies Act 1929 dealing with the prohibition on the giving of financial

assistance by the company in connection with the purchase of its own shares. The Judge was clearly influenced by this decision and indeed set out a lengthy passage from the judgment of Lord Greene MR at pp 240 to 241 (see paragraph 72 of the Decision) which we repeat:

> "The sole question is whether or not the word "purchase" in this section covers a case where the money which the company provides is used to assist a subscription for the company's own shares.…[W]ith all respect to Bennett J., I am unable to agree with the view which he took that the subscription by these three directors for shares in V. G. M. was, within the meaning of the section, a purchase of those shares. In the first place, throughout the whole of the Companies Act, 1929 , the language which is used with regard to the issue of shares to subscribers is invariably confined to words like "issue," "subscription," "application," "allotment," and so forth. There is not a single passage in the Act to which we were referred, or to which my fairly complete recollection of the Act goes, in which the word "purchase" is used in relation to the transaction of subscription. That being so, it seems to me that a very clear context would be required to enable a meaning to be put on the word "purchase" in this section which would extend it so as to cover the acquisition of shares by subscription. Quite apart from those considerations of mere language of the Act, it seems to me that the word "purchase" cannot with propriety be applied to the legal transaction under which a person, by the machinery of application and allotment, becomes a shareholder in the company. He does not purchase anything when he does that. Mr. Wynn Parry endeavoured heroically to establish the proposition that a share before issue was an existing article of property, that it was an existing bundle of rights which a shareholder could properly be said to be purchasing when he acquired it by subscription in the usual way. I am unable to accept that view. A share is a chose in action. A chose in action implies the existence of some person entitled to the rights which are rights in action as distinct from rights in possession, and, until the share is issued, no such person exists. Putting it in a nutshell, the difference between the issue of a share to a subscriber and the purchase of a share from an existing shareholder is the difference between the creation and the transfer of a chose in action. The two legal transactions of the creation of a chose in action and the purchase of a chose in action are quite different in conception and in result. The result, therefore, is that I can find no context in this section which enables me to construe the word "purchase" as bearing the extended meaning suggested, and I cannot agree with the view which Bennett J. took on that part of the case."

129. Mr Gammie of course drew attention to the passage beginning "In the first place….", suggesting that the position is therefore entirely different from the present case. But whether or not that is so, Mr Gardiner relies on this judgment for what follows starting with the words "Quite apart from those considerations of mere language of the Act….". Mr Gammie is, of course, correct that what Lord

Greene said was said in the context of the Act. But drawing attention to that consideration and to what Lord Greene said about the language of the Act, does not provide an answer to Lord Greene's wider consideration of the ordinary meaning of the word "purchase".

130. Mr Gardiner makes similar submissions to us to those he made to the Judge, suggesting quite reasonably that the draftsman has chosen his words carefully in part because he was aware that, where the sections do apply, they create fictions that will need to be carefully controlled. He referred us to the strong endorsement of Lord Greene's classic statement, as it was described, in *McMillan Properties Pty Ltd v WC Penfold* [2001] NSWSC 1173 (another case referred to by the Judge). The distinction has also been recognised the other way round. See for example the judgment of Browne-Wilkinson V-C (as he then was) in *Abbey National Building Society* v *The Building Societies Commission* (1989) 5 BCC 259 at 264:

> "In my judgment the word "subscriber" in [section 100(8) of the Building Societies Act 1986] is basically used in its strict company law meaning, that is to say a person who applies for the allotment by the company of new shares in return for cash payable to the company. A purchase of shares is not a subscription for shares: see *In Re VGM Holdings Ltd* [1942] Ch 235; *Governments Stock and Other Securities Investment Co Ltd* v *Christopher* [1956] 1 All ER 490, [1956] 1 WLR 237."

131. Mr Gammie submits that this decision is only determinative in its own particular context of the Building Society Act 1986. Indeed, he submits that this passage actually confirms HMRC's submission that it is only in the "strict company law" context that the words 'buy' and 'purchase' do not refer to a subscription of shares. The ordinary meaning of the words includes purchase by way of subscription and it is only if the statutory context dictates a narrow, restrictive meaning that subscription should be excluded. We do not agree that that is a proper conclusion to draw from the reference to the "strict company law meaning" as if that meaning were not the ordinary meaning.

132. We do not consider that the present case is to be decided by reference to a wide or narrow starting point with one party or the other being required to show

that the statutory context requires otherwise. We ask ourselves only whether the word "buy" includes a subscription bearing in mind, of course, what has been said in all of the cases which we have referred to, but without regarding them as determinative of the issue one way or the other. In that context it is important to look in slightly more detail at sections 737A(1) and 730A(1).

133. Taking section 737A first, as Mr Gardiner has pointed out, the subsections relevantly refer to a situation where a person (the transferor) agrees to sell any securities and the transferor (or a connected person) "is required to buy them back….". Reading the subsection in isolation, it is abundantly clear that the reacquisition envisaged is of the very same securities as were sold in the first place. There is no question of the substitution in the reacquisition of other securities whether or not in existence at the time of the original sale. So, taking the subsection in isolation, "buy" means, and can only mean, buy existing securities.

134. The subsection is, however, given a wider ambit by section 737B(5). That latter subsection tells us that references to buying back securities includes buying similar securities. The object of that extension is, we suggest, to extend the scope of the securities which will bring the transaction within the ambit of section 737A; it is not to extend the scope of the type of dealing which is to fall within that ambit. In other words, the securities do not need to be the identical securities as were sold; they only need to be similar securities. But they do still need to be subject to an obligation on the part of the transferor to buy them using the word buy in the same sense in which it is used in section 737A(1). In other words, we should read section 737B(5) into section 737A(1) so that paragraph (a) then reads:

> "(a) is required to buy them back or to buy similar securities …."

135. The word "buy" is not to be given different meanings in that resulting provision. The concept of buying similar securities is to be identified conformably with the concept of buying back securities already sold. The similar securities must therefore be in existence at the very latest when the purchase is

completed. A subscription is not, in this sense, a purchase. HMRC ask us, in effect, to read the expanded paragraph (a) in this way:

> "(a) is required to buy them back or to buy or subscribe for similar securities …."

136. We do not consider that this result is justified by the application of section 737B(5) to section 737(1)(a) Exactly the same arguments apply with the same result, to sections 730A(1) and 730B(2).

137. This reading of the legislation is entirely consistent with the economic substance and purpose of a repo transaction: as we have said, it is in substance a form of secured lending – Company A holding securities it does not wish to sell, but in need of cash, sells those securities to Company B on terms whereby Company A will purchase them back (or purchase similar securities held by Company B) to unwind the transaction; the terms of sale and re-purchase and of any fee arrangements determine the financial basis of the "loan". Whilst these arrangements clearly operate in the case of the sale and purchase of securities already in issue, it is far less obvious to bring within their operation a subscription for and issue of new securities, either at the "sale" stage or the "repurchase" stage of the transaction. To achieve that, in the context of the technically-precise repo legislation, would require express provision.

138. If that factor (*ie* giving "buy" the same meaning in the two sections) is insufficient alone to justify our conclusion – it must on any view be <u>a</u> factor – we would start with the meaning of "purchase" identified by Lord Greene. It seems to us to be the more ordinary meaning of the word purchase in the context of dealings in securities, especially in the context of an Act of Parliament where a broader and, we think, more colloquial meaning is not so likely to have been intended. Taking that starting point, we do not consider that there is anything in the legislation to displace it. Indeed, if we thought there were, we could not have arrived at our conclusion based in the interaction of sections 737A(1) and section 737B(5) in the first place.

139. That is enough to dispose of the Repo Issue. The Judge mentioned two other arguments advanced by First Nationwide as to why the sections did not apply but did not express a view on them. These were as follows:

a. Section 737A does not apply since neither the condition in subsection (2)(d) nor (2A)(d) is satisfied. This is because the subscription price payable under the Subscription Agreement only takes account of whether dividends have been paid (rather than who receives them).

b. Section 730A would be disapplied by subsection (8)(b) since, when the First Issued Preference Shares were sold by the Appellant to Anglo Irish Bank, all of the benefits and risks arising from fluctuations in their market value fell on the latter (the interim holder for this purpose).

140. These are quite technical issues. Mr Gardiner simply relied on the written submissions he had presented to the Judge. Mr Gammie said nothing about these issues in oral argument but, with our permission, submitted a written response to Mr Gardiner's submissions subsequently. Like the Judge, we express no view.

Conclusions

141. HMRC's appeal is dismissed. We affirm the decisions of the Judge contained in paragraph 79 of the Decision namely:

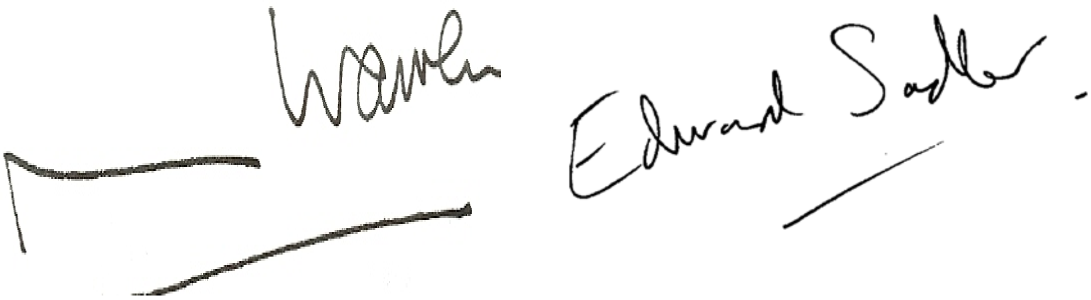
a. Each of the First Preference Dividend and the Second Preference Dividend constitutes a "dividend" for the purposes of paragraph 1(1) of Schedule 23A ICTA and the Income Tax (Manufactured Overseas Dividends) Regulations 1993,

b. Each of the First Preference Dividend and the Second Preference Dividend constitutes an "overseas dividend" for the purposes of paragraph 1(1) of Schedule 23A ICTA and the Income Tax (Manufactured Overseas Dividends) Regulations 1993;

c. The sale of the First Issued Preference Shares by First Nationwide to Anglo Irish Bank and the subscription by First Nationwide for the Second Issued Preference Shares was not a sale and repurchase of securities for the purposes of sections 737A and 730A ICTA (as extended by subsections 737B(5) and 730B(2)(a) respectively to include the case where a person sells securities and buys similar securities).

Costs

142. We order, in accordance with Rule 10 of the Upper Tribunal Rules, that HMRC are to pay First Nationwide's costs of the appeal which, if not agreed, are to be assessed on the standard basis. We specify the High Court for the purposes of Rule 10(9)(a).



Mr Justice Warren	**Edward Sadler**
President	**Upper Tribunal Judge**

Release Date: 18 April 2011