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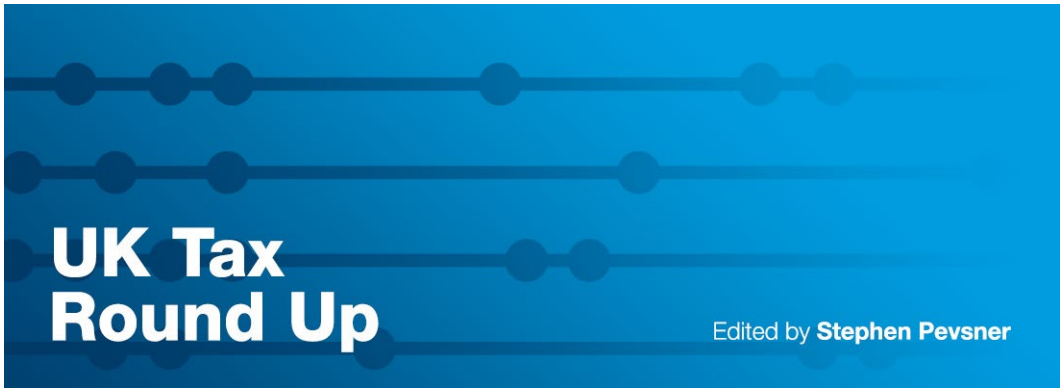

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For more information, please contact:

Stephen Pevsner
Partner
t: +44.20.7280.2041
spevsner@proskauer.com

Robert E. Gaut
Partner
t: +44.20.7280.2064
rgaut@proskauer.com

Richard Miller
Partner
t: +44.20.7280.2028
rmiller@proskauer.com

Frazer Money
Partner
t: +44.20.7280.2223
fmoney@proskauer.com

Catherine Sear
Partner
t: +44.20.7280.2061
csear@proskauer.com

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Welcome to the May edition of our UK Tax Round Up, which discusses two interesting judgments, one on the question of whether a distribution from a Jersey company was of a "capital nature" and the other on whether a loan to a participator in a close company was "released".

UK Case Law Developments

Jersey company dividend paid out of share premium not "dividend of capital nature"

In *Beard v HMRC*, the Court of Appeal (CA) has upheld the decisions of both the Upper Tribunal (UT) and the First-tier Tribunal (FTT) confirming that certain cash and in specie distributions received by the taxpayer, Mr Beard, from Glencore plc were subject to UK income tax rather than capital gains tax. The case turned on the interpretation of the phrase "dividends of a capital nature" in section 402(4) ITTOIA 2005, which excludes such dividends from the charge to income tax.

Mr Beard, a UK resident taxpayer, received distributions of approximately £150 million in aggregate from Glencore plc (Glencore), a Jersey-incorporated and Swiss tax-resident company, between 2011 and 2016. The distributions comprised both cash payments and an in specie distribution by Glencore of shares in one of its subsidiaries, Lonmin plc. All distributions derived from Glencore's share premium account, a reserve built from capital contributions, and were made under Part 17 of the Companies (Jersey) Law 1991.

The UT had found in favour of HMRC, confirming that the correct approach to determine the nature of a dividend from a non-UK company is that set out in the decision on *Rae v Lazard* and other cases, i.e., to determine whether under the relevant corporate law of the entity in question the mechanism used for the distribution means that the corpus of the asset (here the Glencore shares or the capital attached to the shares) is left intact or is eroded (the so called "fruit" or "tree" test). Applying this, the UT concluded that the distributions were dividends and were of an income, rather than a capital, nature since they were paid out of a reserve that Jersey law did not protect as share capital and were paid using the standard Jersey law mechanism for paying dividends. For a more detailed summary of the UT's decision, please refer to the March 2024 UK Tax Round Up.

Mr Beard appealed to the CA on the basis that the UT had misinterpreted the meaning of "dividend of a capital nature" and erred in law in deciding that the distributions in question did not meet this definition. In relation to the dividend in specie, there was an additional ground of appeal that the UT had wrongly characterised this as a "dividend", given that this was an in specie distribution, which would not have been subject to income tax under section 402 ITTOIA.

The CA gave an overview of the statutory framework and case law underpinning the general distinction between income and capital for UK tax purposes. Lady Justice Falk, delivering the lead judgment, emphasised that the phrase "dividend of a capital nature" in section 402(4) ITTOIA must be interpreted in light of longstanding UK tax principles, particularly those developed under the former schedular system, and rejected the argument raised for Mr Beard that the introduction of ITTOIA involved a major change in tax law such that the prior case law principles were no longer determinative, as the legislation expressly contemplated that a dividend (which would, from an English corporate law perspective, be expected to leave the corpus of the share intact) could be capital in nature.

The CA reaffirmed that the determination of whether a distribution is income or capital nature turns primarily on the mechanism used to effect the distribution and the corporate law consequences of it, rather than the source of the funds or the label applied under foreign law. Drawing heavily on the House of Lords' decisions in *Reid's Trustees* and *Rae v Lazard*, the CA reiterated that the relevant test is whether the "corpus of the asset" remains intact after the dividend has been paid applying the legal form and effect of the distribution under the relevant foreign law.

Applying this framework, the CA upheld the FTT's and UT's findings that the distributions paid by Glencore under Part 17 of the Companies (Jersey) Law 1991 were not of a capital nature. Although the distributions were debited to Glencore's share premium account (a capital account under Jersey law), the court found that this was not determinative. What mattered was that the distributions were made using a mechanism (Part 17) that did not require a reduction of capital and was functionally equivalent to the payment of dividends from profits. The court noted that Jersey law had evolved to allow distributions from share premium without court approval or the traditional capital maintenance protections, thereby aligning such payments more closely with income distributions.

The CA also rejected Mr Beard's argument that the in specie distribution of the Lonmin shares should be treated differently. The CA found no meaningful distinction between the cash and in specie distributions, both of which were made under the same legal mechanism and debited to the same reserve. The fact that the Lonmin shares were non-core assets or that the distribution was a one off did not alter its character for tax purposes.

In conclusion, the CA dismissed the appeal, confirming that all of the distributions received by Mr Beard were taxable as income. The judgment provides important clarity on the interpretation of "dividend of a capital nature" and reinforces the principle that the legal form of a distribution made by a non-UK company, rather than its economic substance or source, is paramount in determining its tax treatment under UK law.

Novation results in a release of loan to participator

In *Powell v HMRC*, the FTT has delivered an interesting ruling regarding the income tax consequences of releasing loans to participators in close companies, upholding HMRC's decision to impose an income tax charge under section 415 ITTOIA on Mr Powell, the director and former sole shareholder of Thermoline Limited (Thermoline) on the novation of a loan made by the company to him to Thermoline's parent company (PHSW).

When a close company makes a loan to a participator and the loan remains outstanding 9 months after the end of the accounting period in which the loan is made then, under section 455 CTA 2010, the company is subject to a corporation tax charge (at currently 33.75%), known as a 'loan to participator' charge. The company can then claim a refund of the tax if the loan is repaid or released. As a corollary to this, where the loan is released, section 415 ITTOIA imposes an income tax charge on the individual participator, reflecting the benefit received by such individual, treated as a distribution made by the company.

HMRC had sought to impose an income tax charge on Mr Powell under section 415 ITTOIA as a result of the novation and following Thermoline's claim for repayment of the tax that it had paid. The FTT agreed with the imposition of the income tax charge on Nicholas Powell.

The FTT's decision centered on whether the novation of the loan from Thermoline to PHSW constituted a "release" of the debt owed by Mr Powell to Thermoline, thereby triggering the section 415 charge. Despite acknowledging that the novation involved valuable consideration, with PHSW acquiring the debt receivable in consideration for owing the same amount to Thermoline under a new intercompany loan, the FTT concluded that debt had not been discharged because Thermoline had not been repaid, but Mr Powell no longer owed the debt to Thermoline. Although Mr Powell still owed the money to PHSW, he had been "released" from his debt obligation to Thermoline.

Drawing heavily on the decision in *Collins v Addies*, the FTT reaffirmed the principle that a release is taxable unless the company has effectively recovered its money under the original loan. In *Collins*, the substitution of one debtor for another was held not to constitute repayment or satisfaction. Applying this, the FTT saw no material distinction on the facts, despite the novation in question resulting in replacing the creditor as opposed to the debtor and Mr Powell still owing amounts, albeit not to the original lender, and Thermoline being owed the same amount by PHSW.

On that basis, the FTT refused the appeal, agreeing with HMRC's position that the novation triggered a deemed dividend receipt for Mr Powell under section 415 ITTOIA.

The case shows how carefully taxpayers should consider terms such as "release" where tax could be triggered by seemingly innocuous and commercial transactions. It does not consider what the position was for PHSW and Mr Powell following the novation, and whether there was a new loan to a participator between PHSW and Mr Powell that could lead to a second liability for him under section 415 ITTOIA if he was released from that loan, notwithstanding that he would have only benefited commercially from one loan amount. It will be interesting to see whether the case is appealed, as there is a reasonable amount of tax at stake, and the decision rests on a very fine determination of what is a "release" in the context of the overall transaction.