Red Discretionary Trustees v HM Inspector of Taxes [2003] UKSC SPC00397 (29 December 2003)

STOCK DIVIDEND – discretionary trust – whether Schedule F trust rate applies – words implied into section 249(6) of the Taxes Act 1988 – appeal dismissed

THE SPECIAL COMMISSIONERS

THE RED DISCRETIONARY TRUSTEES **Appellant**

- and -

HM INSPECTOR OF TAXES **Respondent**

Special Commissioners: DR JOHN F AVERY JONES CBE
RICHARD BARLOW

Sitting in private in London on 8 and 9 December 2003

Robert Venables QC and Rory Mullan instructed by Deloitte & Touche LLP for the Appellant

Launcelot Henderson QC instructed by the Solicitor of Inland Revenue for the Respondents

1. This is an appeal by The Red Discretionary Trustees against an amendment to a trust self-assessment increasing the amount of income tax due from £11,205.04 to £2,549,982.30. The appeal raises the issue of whether scrip dividends paid to trustees of a discretionary trust are taxable at the trust rate. The Appellant was represented by Mr Robert Venables QC and Mr Rory Mullan, and the Crown by Mr Launcelot Henderson QC.

Hearing in private

2. The Appellant applied in advance for a hearing in private. Under Regulation 15(2) of the Special Commissioners (Jurisdiction and Procedure) Regulations 1994 as amended by the General Commissioners and Special Commissioners (Jurisdiction and Procedure) (Amendment) Regulations 2002 (SI 2002 No.2976), applying to proceedings commenced on or after 31 December 2002:

> "A Tribunal may direct that all or part of a hearing shall be in private—
>
> (a) upon the application of all the parties by notice to the Clerk;
>
> (b) upon the application of any party by notice to the clerk;
>
> (c) of its own motion,
>
> if in each case, a Tribunal is satisfied that a hearing in private is necessary—
>
> (i) in the interests of morals, public order, national security, juveniles or for the protection of the private life of the party; or
>
> (ii) it considers that publicity would prejudice the interests of justice."

The rules also provide that in cases (2)(b) and (2)(c) the Tribunal shall give the other party or parties to the proceedings the opportunity to make representations, and also that before giving a direction that the entire hearing be in private the Tribunal shall consider whether only part of the hearing should be heard in private.

3. The reasons given for making the application were that the company concerned with the bonus issue in question owns a high profile asset that has attracted a considerable amount of press attention, although it has since been sold; the settlor's family wealth has made the family a target for theft and violence and they have in fact suffered a serious personal attack in which the settlor and members of his family were handcuffed by four robbers at his home and in which a substantial amount of property was stolen. Press reports of the event were provided. The Inspector had no objection to the hearing in private.

4. As we believe this is only the second such application under the amended rule we are setting out the Chairman's reasons for granting the application in this decision for the benefit of those reading this decision when it is published in an anonymised form. The rules clearly state that consent of both parties is in itself not enough; the tribunal must be satisfied about the matters set out in (i) or (ii) of Rule 15(2). There is a public interest in open hearings and a presumption that sittings will be in public unless sufficient reasons are shown that one of those matters is satisfied. In this case given the circumstances of the robbery and its press publicity the Chairman considered that sitting in private is necessary for the protection of the private life of the Appellant to a

greater extent than would ordinarily be the case. Protecting the taxpayer's private life could not be achieved if part of the hearing were in private. Accordingly the Chairman agreed that the hearing would be in private. If it had not been for the press publicity about the robbery the tribunal would probably have decided to sit in public and for figures to be omitted where these were not necessary to an understanding of the decision.

Facts

5. The following facts were agreed:

(1) The Settlement was made on 14th July 1993.

(2) The Red Discretionary Trustees are the current trustees of the Settlement.

(3) The trusts were in broad discretionary form. Clause 5 conferred on the trustees a wide power of appointment exercisable in favour of "the Beneficiaries". "The Beneficiaries" were the Settlor's children and remoter issue and the spouses widows and widowers of such children and remoter issue: see clause 1(A)(d). There was a power conferred on the trustees with the written consent of the settlor to add to the class of Beneficiaries: see clause 3.

(4) Clause 6 (a), (b) and (c) of the Settlement contained discretionary trusts of income in default of appointment, including a power to accumulate income during the Accumulation Period. Clause 6 (d) conferred on the trustees powers of application of capital for the benefit of Beneficiaries. There was an ultimate gift over to charity: see clause 7.

(5) Clause 14 excluded from benefit any settlor of the Settlement and any spouse of such settlor.

(6) Clause 11 of the First Schedule to the Settlement conferred on the trustees power by deed "to revoke or vary any of the administrative provisions of this Settlement or to add any further administrative provisions as the Trustees may consider expedient for the purposes of this Settlement", subject to certain restrictions.

(7) The Settlement itself contained no provisions dealing with distributions of shares in itself by a company of which the trustees were shareholders.

(8) By a Deed of Appointment of 27th May 1999, the then trustees of the Settlement, in "exercise of the power conferred on them by clause 11 of the First Schedule to the Settlement and, in so far as necessary, clause 5 of the Settlement" with the consent of the Settlor and on the advice of Robert Venables Q.C. appointed that the Trust Fund should thenceforth be held on the same trusts and with and subject to the same powers and provisions as were declared in the Settlement but with the addition of a new clause 27 of the First Schedule thereto.

(9) The new clause 27 was headed "Dividends from Companies". Clause 27(1) provided that it should have effect "notwithstanding any provision of this Settlement." Clause 27(2) provided that if at any time the Trust Fund should consist of or include shares in a company in respect of which the

trustees had an option to receive a dividend either in cash or in the form of additional share capital in the company, then the trustees might exercise the option in such manner as they should think fit notwithstanding certain considerations set out in paragraphs (a), (b) and (c).

(10) Clause 27(3) provided that any "cash dividend receivable in respect of any shares in a company which are comprised in the Trust Fund shall be treated as income arising under this Settlement."

(11) Clause 27(4) provided that any "dividend receivable in respect of any shares in a company which are comprised in the Trust Fund shall if it consists of additional shares in the company be and be regarded for all the purposes of this Settlement as part of the capital of the Trust Fund." The subclause was expressed to have effect "in relation to any shares comprised in the Trust Fund during any period in which income arising therefrom could lawfully be accumulated and during such other part or parts of the Trust Period as the law may allow." "The Accumulation Period" under the Settlement was twenty-one years from the date of the Settlement or the Trust Period if shorter: see clause 1(A)(c) of the Settlement. "The Trust Period" was defined, by clause 1(A)(b), to mean "the period ending on the earlier of: (i) the last day of the period of 80 years from the date of this Settlement ... or (ii) such date as the Trustees shall by deed at any time or times specify ...".

(12) The Trust Period has not yet ended. In consequence, the Accumulation Period has not yet ended and clause 27(4) of the First Schedule to the Settlement has had effect at all times since 27th May 1999.

(13) Clause 27(6) provided that no power conferred on the trustees to pay or apply capital of the Trust Fund to or for the benefit of one or more Beneficiaries should during the Specified Period as regards any part of the Trust Fund which was or represented any dividend consisting of additional shares in a company received or receivable from that company as the result of the exercise or non-exercise of an option by the trustees, be exercisable in such a manner that, if it were so exercisable, the additional shares would be "payable at the discretion of the trustees or any other person" within the meaning of Taxes Act 1998 Section 686(2)(a). The "Specified Period" was defined to mean "the period of two years beginning with the date upon which the shares became so receivable by the Trustees".

(14) The initial settled property was seventy ordinary shares in Old Company Limited.

(15) By a Deed of Addition made 1st June 1999, the settlor settled a further cash sum of twenty-one pounds. This cash sum was added to the Settlement to enable the trustees to subscribe for shares as part of a subsequent corporate reorganisation involving Old Company Limited.

(16) The corporate reorganisation involving Old Company Limited took place between May 27th and 1st July 1999. As a result of that reorganisation, the trustees' holding of 70 shares in Old Company Limited came to be

represented by 35 ordinary shares of one pound each in the Company (as well as by shareholdings in two other companies.

(17) The Company was incorporated in England and Wales under the Companies Act 1985 as a private company limited by shares and with a former name.

(18) On 18th May 1999 a special resolution was passed whereby the name of the Company was changed its current name, the memorandum and association of the Company was amended and new articles of association adopted.

(19) On or before 23rd July 1999, the Settlor transferred a sum in the amount of £50,000 to the Company. In a letter of 23rd July 1999 the Settlor confirmed that this sum was paid by way of a cash contribution to the Company. It was acknowledged that the Settlor had no further rights in respect of the sum transferred and any right to repayment was waived.

(20) By letter on 26th July 1999 from Arthur Andersen, the directors of the Company were advised that the cash contribution could be treated as a realised profit and so taken into account in determining distributable profits for dividend purposes.

(21) A special resolution of the Company was passed by all the members of the Company on 28th July 1999.

(22) Paragraph (a) of the special resolution increased the authorised share capital of the Company from £1,000 (comprised of 1000 ordinary shares of one pound each) to £21,000 by the creation of 2,000,000 ordinary shares of one penny each.

(23) Paragraph (b) of the special resolution amended the articles of association of the Company. The amendments included the insertion of a new article 6 which gave the directors of the Company power to offer to holders of a class of share in respect of which a dividend has been authorised by an ordinary resolution of the Company, the right to receive fully paid additional shares in the company instead of the authorised cash dividend. A new article 21 was inserted governing the manner in which meetings of the directors might be held.

(24) Paragraph (c) of the special resolution authorised the directors of the Company pursuant to s.80 of the Companies Act 1980 to exercise the power of the Company to allot relevant securities (as defined in that section) up to a maximum nominal amount of £20,000 for a period expiring on 31 December 1999.

(25) Paragraph (d) of the special resolution authorised the directors of the Company to declare a cash dividend of £20 per ordinary share of one pound in the capital of the Company at any time prior to 31 December 1999. The directors were also authorised, in respect of the dividend, to offer, in accordance with article 6 of the articles of association, the holders of ordinary shares of one pound the right to receive fully paid additional shares in the company of one penny each instead of the cash dividend of £20 per ordinary share.

(26) A meeting of the board of directors of the Company at which the Red Discretionary Trustees were present was held on 28th July 1999. It was resolved at the meeting that a dividend of £20 on each ordinary share of one pound in the capital of the Company be declared. It was further resolved that the shareholders on the register at the close of business on 28th July 1999 should be offered the right to elect to receive for each ordinary share of one pound held by them, 2,000 ordinary shares of one penny each instead of the cash dividend.

(27) On 28th July 1999 a letter setting out the right to elect to receive 70,000 ordinary shares of one penny each in the capital of the Company in place of a dividend of £700 was sent to the trustees of the Settlement. The letter required the election to be received by the Company at its registered office by 5.00 pm British Summer Time on 29th July.

(28) By written resolution made 28th July 1999 (but incorrectly dated, as a result of a clerical error, 29th July 1999), the then trustees of the Settlement resolved to elect to receive in respect of the share capital held by them in the Company, a dividend consisting of further shares in the Company. The reason for so electing was that the shares would be worth much more than the cash.

(29) A Form of Election dated 28th July 1999 was sent to the Company by the trustees of the Settlement.

(30) A meeting of the board of directors of the Company at which the Red Discretionary Trustees (by telephone) were present was held on 30th July 1999. It was noted that all of the shareholders elected to receive shares so that no cash dividend was payable. It was resolved to capitalise £20,000 of the amount standing to the credit of the profit and loss account of the Company and apply it in paying up 2,000,000 ordinary shares of one penny each.

(31) The 70,000 ordinary shares of one penny each in the capital of the Company which the trustees of the Settlement elected to receive were allotted and issued to them on 30th July 1999 pursuant to the resolution of the board meeting on that date.

(32) The trustees of the Settlement subsequently submitted a Trust and Estate Self Assessment Return for the year ended 5 April 2000. The trustees accepted that the market value of the stock dividend fell to be included in their taxable income. They formed the view that it was taxable at the Schedule F ordinary rate of 10 per cent only and not at the Schedule F trust rate of 25 per cent. The Taxing Acts prescribe that all Schedule F income of trustees shall be taxable at the Schedule F ordinary rate but that only certain types of Schedule F income shall be taxable at the Schedule F trust rate.

(33) The trustees in this case inserted a figure of £17,134,971, representing the value of the stock dividend,[1] in box 13.22 of the Return as an "exceptional deduction". In reality, the figure was not a deduction at all, but represented an

[1] The figure of £17,134,971 was subsequently amended to £16,925,155 following agreement with the Shares Valuation Division.

amount which, if the trustees' contention is correct, never fell to be taxed at the Schedule F trust rate at all and so did not need to be deducted. In a note appended to the Return as Schedule "K1" the trustees explained that in their view the stock dividend was to be regarded as trust capital and was not liable to tax at the Schedule F trust rate under s.686 of the Income and Corporation Taxes Act 1988.

(34) The Inland Revenue issued notice of an enquiry on 11 April 2001.

(35) On 7 April 2003 the Inland Revenue concluded its enquiry and amended the Trust Self Assessment by increasing the amount of income tax due from £11,205.04 to £2,549,982.30, i.e. an increase of £2,538,777.26.

(36) By a Notice of Appeal dated 15 April 2003 the trustees appealed against the amendment made to the Trust Self Assessment.

Agreement on law and the issue

6. The following points were agreed:

(1) The stock dividend received by the trustees was as a matter of trust law capital. The position would have been no different had clause 27 not been added to the First Schedule to the Settlement.

(2) If the trustees had elected to take a dividend in cash, it would have constituted income for trust purposes. It would also have constituted income for income tax purposes and would have been income to which section 686 would (at least to some extent) have applied. The position in this regard would have been no different had clause 27 not been added to the First Schedule to the Settlement.

(3) Taxes Act 1988 section 249 applied to the issue of the bonus shares because they fell within section 249(1)(a): " any share capital issued by a company resident in the United Kingdom in consequence of the exercise by any person of an option conferred on him to receive in respect of shares in the company ... either a dividend in cash or additional share capital".

(4) Section 249(6) applied to the issue of the bonus shares as the Company issued "share capital to trustees in respect of any shares in the company held by them ... in a case in which a dividend in cash paid to the trustees in respect of those shares would have been to any extent income to which section 686 applies".

(5) Section 249(4) did not apply as the shares were not, when issued, share capital to which an individual was beneficially entitled.

(6) It is agreed that by virtue of section 249(6) applying:

(a) there was treated as having arisen to the trustees on the due date of issue income chargeable to income tax at (at least) the Schedule F ordinary rate;

(b) the trustees were treated as having paid non-refundable income tax at the Schedule F ordinary rate on the amount of the deemed income; and

(c) the amount of the deemed income was, in the circumstances, the market value of the bonus shares on the date of issue grossed up at the Schedule F ordinary rate for 1999/2000 (10%), i.e. 10/9ths of the market value of the bonus shares.[2]

(7) The sole issue on the appeal is whether the deemed income was chargeable at the (higher) Schedule F trust rate of 25% (with credit being given for tax at the Schedule F ordinary rate of 10%), in accordance with Taxes Act 1988 section 686(1) and (1AA)(a), with the result that the trustees are liable to pay income tax in respect of the receipt of the bonus shares of an amount equal to 15% of the amount of the deemed income (or 16.67 % of their market value at the date of issue).

(8) It is agreed that the income deemed to have arisen to the trustees was "Schedule F type income" as defined in s.686(5A)(e), being income treated as arising to the trustees by virtue of s.249(6)(b).

Statutory provisions

7. Taxes Act 1988 Section 249(1) provides:

"**249 Stock dividends treated as income**

(1) Subject to subsections (7) to (9) below, this section applies to any of the following share capital, that is to say-

(a) any share capital issued by a company resident in the United Kingdom in consequence of the exercise by any person of an option conferred on him to receive in respect of shares in the company (whether the last-mentioned shares were issued before or after the coming into force of this section) either a dividend in cash or additional share capital; and

(b) ...

(3) Where a company issues any share capital in a case in which two or more persons are entitled thereto, the following provisions of this section shall have effect as if the company had issued to each of those persons separately a part of that share capital proportionate to his interest therein on the due date of issue.

(4) Subject to the following provisions of this section, where a company issues any share capital in a case in which an individual is beneficially entitled to that share capital, that individual shall be treated as having received on the due date of issue income of an amount which, if reduced by an amount equal to income tax on that income at the Schedule F ordinary rate for the year of assessment in which that date fell, would be equal to the appropriate amount in cash, and-

(a) the individual shall be treated as having paid income tax at the Schedule F ordinary rate on that income or, if his total income is reduced by any deductions, on so much of it as is part of his total income as so reduced;

(b) no repayment shall be made of income tax treated by virtue of paragraph (a) above as having been paid; and

(c) that income shall be treated (without prejudice to paragraph (a) above) as if it were income to which section 1A applies as it applies to income

---

[2] See section 251(2)(b). The market value of the bonus shares has been agreed.

chargeable under Schedule F, but shall be treated for the purposes of sections 348 and 349(1) as not brought into charge to income tax.

(5) Where a company issues any share capital to the personal representatives of a deceased person as such during the administration period, the amount of income which, if the case had been one in which an individual was beneficially entitled to that share capital, that individual would have been treated under subsection (4) above as having received shall be deemed for the purposes of Part XVI to be part of the aggregate income of the estate of the deceased.

This subsection shall be construed as if it were contained in Part XVI."

(6) Where a company issues any share capital to trustees in respect of any shares in the company held by them (or by them and one or more other persons) in a case in which a dividend in cash paid to the trustees in respect of those shares would have been to any extent income to which section 686 applies, then-

(a) there shall be ascertained the amount of income which, if the case had been one in which an individual was beneficially entitled to that share capital, that individual would have been treated under subsection (4) above as having received; and

[The effect of the incorporation is that the amount is:

"an amount which, if reduced by an amount equal to income tax on that income at the Schedule F ordinary rate for the year of assessment in which that date [the due date of issue] fell, would be equal to the appropriate amount in cash."]

(b) income of that amount shall be treated as having arisen to the trustees on the due date of issue and as if it had been chargeable to income tax at the Schedule F ordinary rate; and

(c) paragraphs (a) to (c) of subsection (4) above shall, with the substitution of "income" for "total income" and with all other necessary modifications, apply to that income as they apply to income which an individual is treated as having received under that subsection."

[The effect of such incorporation is as follows:

"(a) the *trustees* ~~individual~~ shall be treated as having paid income tax at the Schedule F ordinary rate on that income or, if *their* ~~his total~~ income is reduced by any deductions, on so much of it as is part of *their* ~~his total~~ income as so reduced;

(b) no repayment shall be made of income tax treated by virtue of paragraph (a) above as having been paid; and

(c) that income shall be treated (without prejudice to paragraph (a) above) as if it were income to which section 1A applies as it applies to income chargeable under Schedule F, but shall be treated for the purposes of sections 348 and 349(1) as not brought into charge to income tax."]

Section 686

"(1) So far as income arising to trustees is income to which this section applies it shall be chargeable to income tax at the rate applicable in accordance with subsection

(1AA) below, instead of at the basic rate or, in accordance with section 1A, at the lower rate or the Schedule F ordinary rate.

(1AA) The rate applicable in accordance with this subsection is—

(a) in the case of so much of any income to which this section applies as is Schedule F type income, the Schedule F trust rate;….

(1A) In relation to any year of assessment for which income tax is charged—

(a) the Schedule F trust rate shall be 25 per cent,….

(2) This section applies to income arising to trustees in any year of assessment so far as it-

(a) is income which is to be accumulated or which is payable at the discretion of the trustees or any other person (whether or not the trustees have power to accumulate it); and

(b) is not, before being distributed, either-

(i) the income of any person other than the trustees, or

(ii) treated for any of the purposes of the Income Tax Acts as the income of a settlor;

(c) is not income arising under a trust established for charitable purposes only or, subject to sub-s (6A) below, income from investments, deposits or other property held-

(i) for the purposes of a fund or scheme established for the sole purpose of providing relevant benefits within the meaning of section 612; or

(ii) for the purposes of a personal pension scheme (within the meaning of section 630) which makes provision only for benefits such as are mentioned in section 633; …

(5A) In this section 'Schedule F type income,' in relation to trustees, means—

…

(e) income treated as arising to the trustees by virtue of section 249(6)(b)…."

Section 687

"(1) Where in any year of assessment trustees make a payment to any person in the exercise of a discretion, whether a discretion exercisable by them or by any other person, then if the payment-

(a) is for all the purposes of the Income Tax Acts income of the person to whom it is made (but would not be his income if it were not made to him), or

(b) ...

the following provisions of this section apply with respect to the payment in lieu of section 348 or 349(1).

(2) The payment shall be treated as a net amount corresponding to a gross amount from which tax has been deducted at the rate applicable to trusts for the year in which the payment is made; and the sum treated as so deducted shall be treated-

(a) as income tax paid by the person to whom the payment is made ...; and

(b) so far as not set off under the following provisions of this section, as income tax assessable on the trustees.

(3) The following amounts, so far as not previously allowed, shall be set against the amount assessable (apart from this subsection) on the trustees in pursuance of subsection (2)(b) above-

…

(b) the amount of tax at a rate equal to the difference between the Schedule F ordinary rate and the Schedule F trust rate on any sum treated, under section 249(6), as income of the trustees;

The Appellant's contentions

8. Mr Venables QC provided a detailed 44 page skeleton of which this is a brief summary. He contends that section 249 subjects the stock dividend only to tax at the Schedule F ordinary rate, and (which is common ground) section 686 on its own does not apply because the stock dividend in this case is not income for trust law purposes, which it must be in order to be "income to which this section applies" within section 686(2). In order to charge the stock dividend to the Schedule F trust rate there needs to be a clear charging provision, see *Greenalls Management Ltd v Commissioners of Customs and Excise* [2003] EWCA Civ 896 at paragraph 26 "the principle ... that if a tax is to be imposed it should be done in clear language." No such charging provision existed. The fact that the draftsman appears to have presupposed that stock dividends were taxable is insufficient. The definition in section 686(5A) of Schedule F type income to include "income treated as arising to the trustees by virtue of section 249(6)(b)" and the credit for tax at the difference between the Schedule F trust rate and the Schedule F ordinary rate "on any sum treated, under section 249(6), as income of the trustees" were necessary to deal with the case where the stock dividend was income for trust law purposes, for example where it was of similar value to the cash alternative, in which case section 686 applied in the normal way.

9. Mr Venables QC pointed to many instances where something that is capital for trust law but income for tax law is taxed at the trust rate. This is done either by deeming the type of deemed income to be income to which section 686 applies,[3] or by imposing tax at the rate applicable to trusts.[4] (There are also some instances where no additional tax is imposed on trusts.[5]) He contended that similar wording was necessary to impose a charge to tax at the trust rate, which was missing from section 249.

10. He contended that the whole stock dividend legislation was misconceived and full of anomalies. For example, where a stock dividend was income treated as the

---

[3] TA 1988 s.686A (purchase of own shares, which excludes income already within s.686(2), income treated as that of the settlor, income of a charitable trust and of certain pension funds, thus reproducing the exclusions from s.686(2)(b) and (c)), Sch 5AA para.7 (guaranteed returns on transactions in futures and options, which is subject to the same three exclusions).

[4] TA 1988 s.547(9) (life policies chargeable events), 720 (accrued income scheme), 764 (offshore funds), FA 1998 s.68(2)c) (chargeable events under employee share ownership trusts), FA 1996 Sch 13 para.6(1)(c) (relevant discounted securities, and its predecessors deep discounted securities TA 1988 Sch 4 para. 17, and relevant discounted securities FA 1989 Sch 11 para.11), former FA 1990 Sch 10 para.19 (convertible securities), former development gains FA 1974 S.43(1).

[5] TA 1988 s.34 (lease premiums), 776 (transactions in land).

settlor's there was no charge to tax at the settlor's rate; the settlor was not beneficially entitled to the stock dividend and so section 249(4) was inapplicable, and such income was excluded from section 686 by subsection (2)(b)(ii). Section 249(6) was not pointless, as suggested by Mr Henderson QC; the policy was not to subject capital for trust purposes to the higher rate charge. The situation was no different from giving non-residents a tax credit at the Schedule F ordinary rate.

The Respondent's contentions

11. Mr Henderson QC posed the question as whether the income deemed by section 249 to arise was taxable under section 686, not whether the stock dividend was so taxable. Section 249(6) was clearly designed to have some purpose which was to subject the deemed income to tax at the Schedule F trust rate, as a result of which the trustees obtained a new market value base value for capital gains tax under section 142 of the Taxation of Chargeable Gains Act 1992. If the Appellant were right its only effect is to attach a non-repayable tax credit to the stock dividend with no further tax being payable.

12. Section 686 is mentioned in the opening words of section 249(6) which is a strong indication that subsection (6) was intended to engage with section 686. The first limb of subsection (6) deems the trustees to have received income instead of the stock dividend. The reference to income being treated as having arisen to trustees in the first limb of subsection (6)(b) mirrors section 686(1). It would be bizarre if the draftsman, having expressly confined the scope of subsection (6) to cases here a hypothetical cash dividend would be within section 686, and having then expressly deemed the trustees to be in receipt of income comprising an amount of money instead of the shares, had not also intended the deemed income to fall within section 686 in the same way as the hypothetical cash dividend. Confirmation is provided by the reference to subsection (6) in section 686(5A) in the definition of Schedule F type income, and the credit in section 687(3)(b). If the Appellant were right all that subsection (6) does is to confer an irrecoverable tax credit on the trustees at the Schedule F ordinary rate, for which they receive a capital gains tax uplift in base value to market value, in contrast to the charge to tax on individuals at the Schedule F upper rate.

Reasons for our decision

13. Section 249 is an unsatisfactory section and in particular subsection (6)(b) does not state clearly what the draftsman was trying to do. Looking at the section as a whole, there are three separate charging provisions: subsection (4) applying where an individual is beneficially entitled to the new shares, subsection (5) applying to personal representatives and subsection (6) applying to trustees. The section contains a lot of deeming. There was no disagreement between the parties that the correct approach to the interpretation of deeming provisions was that set out by Peter Gibson J in the Court of Appeal in *Marshall v Kerr* 67 TC 56, 79A:

> "For my part, I take the correct approach in construing a deeming provision to be to give the words used their ordinary and natural meaning, consistent so far as possible with the policy of the Act and the purposes of the provisions so far as such policy and purposes can be ascertained; but if such construction would lead to injustice or absurdity, the application of the statutory fiction should be limited to the extent needed to avoid such injustice or absurdity, unless such application would clearly be

> within the purposes of the fiction. I further bear in mind that, because one must treat as real that which is only deemed to be so, one must treat as real the consequences and incidents inevitably flowing from or accompanying that deemed state of affairs, unless prohibited from doing so."

14. Section 249(6) starts with the real world of the trustees receiving the bonus shares: "Where a company issues any share capital to trustees in respect of any shares in the company held by them…". It then creates a contrary-to-fact hypothesis that the trustees have instead received a dividend in cash: "in a case in which a dividend in cash paid to the trustees in respect of those shares would have been to any extent income to which section 686 applies." It is common ground that section 686 would have applied to a cash dividend because we are dealing with a discretionary trust. The subsection continues "then—", thus firmly connecting this introduction to the three following lettered paragraphs. If one stopped reading at that point one would expect that, having established that section 686 applied on the basis of the hypothesis of a cash dividend, the draftsman would then apply that section to the real world receipt of bonus shares (or their deemed income equivalent). He failed to do this in so many words. If he had, the argument in this case would never have arisen. The issue is whether he has done so sufficiently by implication.

15. Continuing with paragraph (a), the draftsman has obviously cancelled the first hypothesis and has gone back to the reality of trustees receiving bonus shares. The draftsman then establishes another contrary-to-fact hypothesis, that the bonus shares had been received beneficially by an individual, in order to ascertain an amount: "the amount of income which, if the case had been one in which an individual was beneficially entitled to that share capital, that individual would have been treated under subsection (4) as having received.". The effect of applying that hypothesis is to establish the amount of income as the "amount which, if reduced by an amount equal to income tax on that income at the Schedule F ordinary rate for the year of assessment in which that date [the due date of issue] fell, would be equal to the appropriate amount in cash," the last expression meaning, in our case where the value of the bonus shares (£15.225m) is substantially different from the amount of the cash alternative (£700), the market value of the bonus shares. The amount is therefore the value of the bonus shares grossed-up at 10 per cent. Next, paragraph (b), the interpretation of which is the main issue in this appeal, starts with that amount and applies two separate deeming provisions "[1] income of that amount shall be treated as having arisen to the trustees on the due date of issue and [2] as if it had been chargeable to income tax at the Schedule F ordinary rate." Finally, paragraph (c) applies part of subsection (4) by reference to "that income." The reference to 'that income' in the last clause in paragraph (6)(c) is clearly not the same thing as "income which an individual is treated as having received" in that clause and "that income" must refer to the income treated as having arisen to the trustees by paragraph (6)(b). The effect of paragraph (6)(c) is to incorporate some of the consequences of that treatment, namely those set out in paragraphs (a) to (c) of subsection (4) but with the necessary changes having been made to the wording of those paragraphs. This has the following results first, "([c]a) that the [trustees] shall be treated as having paid income tax at the Schedule F ordinary rate on that income" [omitting reference to expenses]; secondly, "([c]b) no repayment shall be made of income tax treated by virtue of paragraph ([c]a) above as having been paid"; and thirdly "([c]c) that income

shall be treated (without prejudice to paragraph ([c]a) above) as if it were income to which section 1A applies as it applies to income chargeable under Schedule F, but shall be treated for the purposes of sections 348 and 349(1) as not brought into charge to income tax." The effect of applying section 1A is that the rate of tax is the Schedule F ordinary rate of 10 per cent.

16. Most of subsection (6) therefore operates by incorporating by reference parts of subsection (4), which relates to an individual beneficially entitled to the bonus shares. The amount of deeming seems to be excessive. Paragraph (6)(a) directs one first to carry out the same grossing up exercise as would be required in the case of an individual to whom subsection (4) applies by grossing-up the value of the bonus shares at the Schedule F ordinary rate; that amount is treated as if it had been chargeable to income tax at the Schedule F ordinary rate; the trustees are treated as having paid income tax at the Schedule F ordinary rate; and finally the income is treated as if it were Schedule F income to which section 1A applies, which means taxable at the Schedule F ordinary rate. The section has been amended in six places, and section 686 in 12 places to take account of matters such as the introduction of the lower rate of tax in 1978/79, rate applicable to trusts in 1993/94, the lower rate of tax on savings income in 1996/97, and the Schedule F ordinary, and Schedule F trust, rates in 1999/2000. Both parties agreed that we were entitled within the principle in *R v Secretary of State for the Environment ex p. Spath Holme Limited* [2001] 2 AC 394 to look at the sections as they were when originally enacted. We have decided to take the unusual step of construing the section as originally enacted because it is much clearer. We set out what is now section 249(6), originally section 34 of the Finance (No.2) Act 1975, and what is now section 686(1), originally section 16 of the Finance Act 1973, as originally enacted:

> **Section 34(6) of the Finance (No.2) Act 1975**
>
> (6) Where a company issues any share capital to which this section applies to trustees in respect of any shares in the company held by them (or by them and one or more other persons) in a case in which a dividend in cash paid to the trustees in respect of those shares would have been to any extent income to which section 16 of the Finance Act 1973 (charge to additional rate on certain income of discretionary trusts) applies, then-
>
> (a) there shall be ascertained the amount of income which, if the case had been one in which an individual was beneficially entitled to that share capital, that individual would have been treated under subsection (4) above as having received; and
>
> [The effect of the incorporation is that the amount is:
>
> "income of an amount which, if reduced by an amount equal to income tax thereon at the basic rate for the year of assessment in which that date [the due date of issue] fell, would be equal to the appropriate amount in cash."]
>
> (b) income of that amount shall be treated as having arisen to the trustees on the due date of issue and as if it had been chargeable to income tax at the basic rate; and
>
> (c) paragraphs (a) to (c) of subsection (4) above shall, with the substitution of "income" for "total income" and with all other necessary modifications,

apply to that income as they apply to income which an individual is treated as having received under that subsection."

[The effect of such incorporation is as follows:

"(a) no assessment shall be made on the *trustees* ~~individual~~ in respect of income tax at the basic rate on the said income but *they* ~~he~~ shall be treated as having paid income tax at the basic rate on it or, if *their* ~~his total~~ income is reduced by any deductions, on so much of the said income as is part of *their* ~~his total~~ income as so reduced;

(b) no repayment shall be made of income tax treated by virtue of paragraph (a) above as having been paid; and

(c) that income shall be treated for the purposes of section 52 and 53 of the Taxes Act [1970] as not brought into charge to income tax."]

Section 16(1) of the Finance Act 1973

(1) So far as income arising to trustees is income to which this section applies it shall, in addition to being chargeable to income tax at the basic rate, be chargeable at the additional rate.

17. The effect of subsection (6) is now much clearer: one grosses up the market value of the stock dividend at the basic rate, income of that amount is treated as if it had been chargeable to tax at the basic rate, no assessment shall be made at the basic rate, but the trustees are treated as having paid tax at the basic rate. Subsection (4)(a), incorporated by subsection (6)(c), expressly prevents the trustees from being assessed but treats them as having paid tax at the basic rate. Turning to section 16, the additional rate is chargeable on income to which that section applied in addition to being chargeable at the basic rate. One can see that, since the deemed income comprising the stock dividend is expressly not chargeable to tax, subsection (6)(b) needs to treat the income as if it had been chargeable at the basic rate in order for the additional rate to apply since the charge at the additional rate is in addition to the income being chargeable at the basic rate. Subsection (6)(b) also treats the deemed income as having arisen to trustees, words that are used at the start of section 16(1). Thus subsection (6)(b) serves to satisfy the condition for the application of the additional rate created by section 16, namely that the income was first chargeable or, here treated as chargeable, at the basic rate which is necessary before an additional rate can be chargeable. That subsection also determines the timing of the deemed income which is necessary to the application of the grossing up in paragraph (a). The incorporations made by paragraph (6)(c) merely provide that, although the deemed income is not assessable, tax is treated as having been paid at the basic rate.

18. Going back to the start of subsection (6) the purpose of asking whether section 16 would apply to a cash dividend is to distinguish trusts to which section 16 applies, broadly discretionary and accumulating trusts, so as to limit the effect of section 34 to such trusts. Because he made the hypothesis about cash dividends the draftsman obviously realised that, even if the terms of the trust made section 16 applicable, it could not apply to the actual stock dividend because it was capital for trust purposes. Next, with an eye to section 16 he treated the deemed income as having arisen to the trustees, and as if it had been chargeable to tax at the basic rate, the latter being a precondition for taxing at the additional rate. What is quite clear is that he was trying

to make section 16 apply to the deemed income. If Mr Venables QC is right in his contentions the effect is that the draftsman taxed the stock dividend at the additional rate only in those circumstances where the stock dividend was income for trust law purposes, for example where the stock dividend was roughly equivalent in value to the cash alternative. That cannot have been his intention because there would be no need for the hypothesis of a cash dividend; he could just have referred to the case in which the trusts were such that section 16 applied. What is missing is a statement that the deemed income (as opposed to the hypothetical cash dividend) is to be treated as income to which section 16 applies, that is to say that it is to be treated as income for trust law purposes, or alternatively a statement that section 16 is to apply to the deemed income. Perhaps he thought mistakenly that it was sufficient to establish that the section applied to the hypothetical cash dividend. Given that we are sure about the draftsman's intention, can we imply that section 34 also said something on the following lines? (No doubt the drafting could be improved but we are trying to suggest an addition that leaves the rest of the wording of paragraph (b) as it stands.)

> "(b) [S*ection 16 shall apply on the basis that*] income of that amount shall be treated as having arisen to the trustees on the due date of issue and as if it had been chargeable to income tax at the Schedule F ordinary rate."

We consider that we can. The whole purpose of subsection (6)(b) is to make section 16 apply, and the whole purpose of section 16 is to impose tax at the additional rate. Any other interpretation defeats the clear purpose of paragraph (b). We fully accept that clear words are necessary to impose a tax charge but we consider that the application of section 16 is sufficiently clear from the whole context.

19. Having established the statutory purpose behind section 34 as originally enacted we consider that such purpose must carry on however much the section is amended to deal with different rates of tax on different types of income. The amendments are consequential to these changes and do not change the fundamental nature of the section. Section 686 now charges the full rates of tax instead of the basic rate, whereas section 16 only charged the additional rate, that completely obscured the reason for subsection (6)(b) treating the deemed income as if had been chargeable at what used to be the basic rate. We therefore come to the same conclusion on the interpretation of section 249 of the Taxes Act 1988 as in force at the date of the stock dividend in question as we did with section 34.

20. Accordingly, we dismiss the appeal and confirm the amendment to the self-assessment in the agreed sum of £2,537,499.90.

21. In accordance with section 56A(2) of the Taxes Management Act 1970 we hereby certify that our decision involves a point of law relating wholly or mainly to the construction of an enactment that has been fully argued before us and fully considered by us. This means that if both parties consent, and if the leave of the Court of Appeal is obtained, the Appellant may appeal from our decision directly to the Court of Appeal.

J F AVERY JONES

RICHARD BARLOW
SPECIAL COMMISSIONERS

SC 3019/03

Authorities referred to in skeletons and not referred to in the decision:
Bouche v Sproule (1887) 12 App Cas 385
Re Malam [1894] 3 Ch 578
IRC v Berrill [1981] 1 WLR 1449
Sinclair v Lee [1993] Ch 497
Padmore v IRC (No.2) [2001] STC 280
Carver v Duncan [1985] AC 1082
In re Taylor Waters v Taylor [1926] Ch 923
IRC v Blott [1921] AC 171
IRC v Wright [1927] 1 KB 333
Hill v Permanent Trustee Company of New South Wales [1930] AC 720