These notes refer to the Finance Act 2009 (c.10) which received Royal Assent on 21 July 2009

FINANCE ACT 2009

EXPLANATORY NOTES

INTRODUCTION

Section 28Schedule 9: Preference Shares - Group Relief

Summary

1. Section 28 and Schedule 9 provide that holders of certain preference shares, including those commonly issued by financial institutions as part of their regulatory Tier 1 capital base, are not treated as equity holders of a company. Previously only the holders of fixed-rate preference shares qualified for this exclusion. It is necessary to distinguish between equity holders and non-equity holders in order to identify companies that are sufficiently under common ownership so as to be regarded as belonging to the same group for tax purposes.

Details of the Schedule

2. Paragraph 1 introduces the amendments which follow. These amend Schedule 18 to the Income and Corporation Taxes Act 1988 (ICTA).

3. The rules in Schedule 18 to ICTA establish who are to be regarded as the equity holders in a company and to what extent, by reference to their shareholdings or entitlement to share in the company's distributable profits or assets. The rules are used primarily to determine a company's entitlement to surrender or claim group relief from related companies for trading losses and other amounts. A number of other tax provisions rely upon the rules in Schedule 18. Those provisions include chargeable gains, real estate investment trusts, venture capital relief and leasing rules.

4. Paragraph 2 details the amendments to paragraph 1 of Schedule 18 to ICTA. The previous exclusion from treatment as an equity holder for holders of 'fixed-rate preference shares' is replaced by a new exclusion for holders of 'relevant preference shares'. Relevant preference shares must be issued for new consideration, so cannot, for example, be a bonus issue. They may carry either no rights to dividends, or rights which fulfil the conditions set out in new paragraph 1A of Schedule 18 to ICTA. Shares which carry no rights to dividends are explicitly included as relevant rate preference shares.

5. Paragraph 3 inserts new paragraph 1A into Schedule 18 to ICTA. This sets out the rights to dividends carried by shares that are relevant preference shares. The holders of relevant preference shares are not treated as equity holders in a company. It is necessary to distinguish between equity holders and non-equity holders in order to identify companies that are sufficiently under common ownership so as to be regarded as belonging to the same group for tax purposes.

6. New paragraph 1A(1) determines that where preference shares carry a right to a dividend, they will be relevant preference shares if they fulfil the 'reasonable commercial return' condition and one of conditions A, B or C set out in the following sub-paragraphs. The reasonable commercial return condition is carried over from the definition of a fixed-rate preference share, so is unchanged.

7. New paragraph 1A(2) sets out condition A. This is met by shares that carry rights to a dividend and would previously have been regarded as fixed-rate preference shares.

8. New paragraph 1A(3) sets out condition B. This is met where the dividend payable on the shares is not fixed absolutely, but is fixed by reference to a published variable rate, either a market rate of interest such as a central bank base rate, or to an appropriate retail prices index.

9. Both conditions A and B are further qualified to ensure that the terms under which the shares are issued do not grant the issuer a right to pay dividends of less than the nominal rate. Where shares are issued under such terms, then condition C is relevant.

10. New paragraph 1A(4) sets out condition C. This is met in cases where condition A or B would have been met, but for the fact that the company has a right to reduce the dividends paid on the preference shares below the nominal rate in circumstances that are covered by the ‘relevant circumstances’ set out in new paragraph 1A(5).

11. If the terms under which the shares have been issued clearly permit the company to reduce or not to pay the dividends only in these relevant circumstances, and no other, then condition C will be met by virtue of new paragraph 1A(4)(a).

12. However, there will be some circumstances in which the terms on which shares are issued are not in fact explicit. For example, the terms of issue may grant the directors of the company a degree of discretion as to whether to pay a dividend, or to pay a reduced dividend. In such cases, new paragraph 1A(4)(b) allows wider factors to be taken into account so that condition C will be met where having regard to all the circumstances it is reasonable to assume that the company is likely to reduce or not to pay the dividends in the relevant circumstances, and no other.

13. New paragraph 1A(5) sets out the relevant circumstances for the purposes of the preceding sub-paragraph. The first circumstance is when the company is in severe financial difficulties at the time the dividend is or would be payable. The second circumstance covers the situation where the dividend is reduced or not paid in order to follow a recommendation of a relevant regulatory body.

14. New paragraph 1A(6) provides a power for the Treasury to make an order specifying what will be regarded as constituting ‘severe financial difficulties’ for these purposes.

15. New paragraph 1A(7) defines a “relevant regulatory body” in terms which cover the Financial Services Authority in the UK or an equivalent regulator in another State.

16. Paragraph 5 is the commencement rule. Shares can be relevant preference shares in relation to any accounting period that commences on or after 1 January 2008, irrespective of when the shares were issued.

17. Paragraph 6 permits a company to make an election to disregard the new rules for ‘relevant preference shares’ in respect of any shares that it had already issued, or was about to issue, when the changes were first announced by a Written Ministerial Statement on 18 December 2008. Apart from shares that were in the process of being issued, an election will not have any effect for shares issued after 18 December 2008, where the revised rules will apply.

18. Paragraph 7 sets out how make an election, and specifies that once made, it cannot be withdrawn.

19. Paragraph 8 ensures that the changes to Schedule 18 to ICTA do not change the meaning of a ‘fixed-rate preference share’ for the purposes of the controlled foreign company rules in paragraph 1(7) of Schedule 25 to ICTA.

Background Note

20. The policy underlying these changes is that the holders of preference shares that provide the holder with no more than an interest like return should not be regarded as equity holders in the issuing company.

21. The central change introduced by this section and Schedule was announced by a Written Ministerial Statement on 18 December 2008. A copy of that statement is available on the HMRC website.