Statement of Practice (SP 6/10)

Tax treatment of Dividends on Redeemable Preference Shares

This Statement of Practice aims at clarifying the tax treatment of dividends on redeemable preference shares given in TR 7 issued in September 1998 and TR 82 issued in September 2008.

2. TR 7 and TR 82 are concerned with redeemable preference shares which can be classified in the balance sheet as liability or equity in compliance with Accounting Standards.

3. In TR 7, 360-day preference shares were to be issued to the existing shareholders. According to the terms and conditions of the issue, redemption would be mandatory and the company would be bound to pay dividends. The company proposed to account for the transaction as a short-term loan rather than equity on the basis of its economic substance and the payment thereon as interest. The ruling given in TR7 was that though Accounting Standards entitled the company to classify the preference shares as a short-term loan, the tax treatment should not necessarily follow the accounting treatment, and that the distribution would be treated as dividends and not interest.

4. At the time the ruling in TR 7 was issued, "dividends" did not have the same definition in the Income Tax Act as that given by Finance Act 2001. According to the new definition "dividends" means a *"distribution authorized by the Board of Directors of a company and made out of the retained earnings of the company, after having made good any accumulated losses at the beginning of its accounting period, either in cash or in shares to its shareholders."* This definition in fact is in line with that in Section 63 (2) (c) of the Companies Act 2001 which requires that "*the Board shall not authorize a dividend unless it is paid out of retained earnings, after having made good any accumulated losses at the beginning of its accounting period."*

5. In TR 82, the company operating as a collective investment scheme categorized the

preference shares as liabilities in the balance sheet and, in lieu of a performance fee which is an allowable expense in accordance with accounting practice, a preference share dividend based on the performance of the company was declared and paid to the manager. The ruling was given in the light of the new definition of “dividends” (cf paragraph 4 above).

6. In deciding whether the return or distribution on redeemable preference shares should be considered as dividend or interest, regard should be had to the terms of the contract of issue, and whether or not the return or distribution satisfies the definition of “dividends” given in the Income Tax Act.

7. If the payment is authorized by the Board of Directors and paid out of the company's retained earnings after having made good any accumulated losses, it should be considered as dividends. Where the payment is considered as dividends it will not be an allowable expense for the company and it will be exempt in the hands of the recipient.

8. On the other hand, if the payment is regarded as interest it will be deductible for the purpose of computing the paying company's chargeable income and taxable in the hands of the recipient. Moreover, the payment will be subject to tax deduction at source (TDS).

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