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Readers' forum: Alphabet conundrum

Directors' share arrangements and entrepreneurs' relief.

I act for some private company clients for which the director/shareholders have implemented 'alphabet share' arrangements. The shares are organised into A, B, C, D shares and so forth, so that dividends of different amounts can be paid to each shareholder/director as a tax-efficient way of paying bonuses. Typically, the shares don't carry any rights to a fixed dividend and no order of priority is set out in the company's articles. Each year the directors determine the dividend (if any) to be paid on each share.

I know there are concerns that these sorts of arrangements are vulnerable to challenge under ITEPA 2003, Pt 7 but my experience is that HMRC rarely challenges them and that they are very common in practice.

I am now concerned that these arrangements could deny the shareholders entrepreneurs' relief, even though all the usual qualifying conditions are met. This is because of the announcement in October's Budget that, to qualify for relief, shareholders must be beneficially entitled to at least 5% of the profits available for distribution.

In a typical alphabet structure there is no set order of priority. If a dividend were paid at the end of the year none of the shareholders would have any entitlement – it would be up to the directors to make that decision. Am I worrying too much or has this change been introduced deliberately to discourage the use of these alphabet arrangements?

Readers' comments are welcomed.

Query 19,272– Dictionary Man.

Reply by Pete Miller, The Miller Partnership.

Alphabet shares appear not to be the target of Budget changes.

There has clearly been much concern about alphabet shares since the announcement on 29 October and these concerns are being followed up with HMRC. The messages coming back suggest that alphabet shares are not the target of the change, which is fairly obvious from the original statement that only 1,000 people or so each year are likely to be affected. However, I understand that the Revenue has also said there is unlikely to be any helpful guidance in this area, at least until after Christmas.

On a technical level, my personal view is that the alphabet shares do not mean that the shareholders fail the 5% test in terms of the availability of dividend. I have always considered this test, which is used in a range of corporate situations – group relief, capital gains groups, substantial shareholding exemption and so on – as being a negative one. That is, we need to ask whether the shareholding denies the shareholder the rights to the relevant percentage of distributable reserves. So, for the purposes of the substantial shareholding exemption, a substantial shareholding is one where the corporate owner has at least 10% of the ordinary share capital and rights to at least 10% of the reserves available for distribution to equity holders. If the shareholding does not, therefore, give the company the right to 10% of the distributable reserves, perhaps because the dividend rights are restricted, or because the shareholding is less than 10%, the test is failed. Unfortunately, despite having dealt with this test in a corporate arena for many years, I haven't had to consider alphabet shares.

However, I think the answer lies in CTA 2010, s 165. This says that, in determining an entitlement to dividends, we have to assume that the company's total profits for the period are distributed to the shareholders (or, if there are no profits, use a hypothetical £100). In the context of alphabet shares I would assume this meant that each shareholder was entitled to a share of the distributable profits based on their proportionate shareholding, and that the test at s 165 does not hypothesise any specific allocations regarding the alphabet nature of the shares.

Nevertheless, I appreciate the concerns and that anyone entering into such arrangements would like to be given as much reassurance as possible, preferably directly from HMRC rather than through my personal analysis.

I consider it extremely disappointing that the department has given no guidance on an important issue of wide concern.

Reply by ANA

Discretion on the payment of dividends may mean new tests are not met.

Dictionary Man is right to be concerned about the impact of the recent announcement on alphabet share structures. Entrepreneurs' relief under TCGA 1992, Pt V ch 3 is available on the disposal of shares in the taxpayer's personal company. Until 29 October 2018, alphabet shares with restricted rights to dividends or to assets on a winding-up normally qualified for relief because the definition of ordinary share capital covered all shares with voting rights except fixed-rate preference shares.

In the Budget, it was announced that two new tests would be added to the personal company definition from 29 October. As well as the current requirements to be an officer or employee of the company, hold 5% of the ordinary share capital and 5% of the voting rights, taxpayers must now be entitled to at least 5% of the distributable profits and net assets available to equity holders on a winding-up.

On the face of it, alphabet shares with discretion on the payment of differential dividends will not meet the new tests. Dictionary Man will need to advise his clients to amend the rights attached to the shares. However, he should also note the Budget announcement that, from 6 April 2019, the qualifying conditions, including the changes to the definition of a personal company as set out above, will have to be met for at least two years ending with the date of disposal or the cessation of trading, if earlier.

Editorial Note.

Readers may also refer Kevin Slevin's recent article 'Not so funny' (*Taxation*, 22 November 2018, page 18).

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