Dividends out of Capital Profits
Some questions and answers

Q1 What has changed?

It is no longer a requirement for a company which is seeking to obtain investment trust status to prohibit the payment of dividends out of capital profits in the memorandum or articles of association. The definition of “investment company” in company law has also been amended in the same way.

The effect of this is that investment trusts will be able to pay dividends out of capital profits, putting investment trusts on a level playing field with offshore investment companies.

Q2 When do these changes apply?

The tax changes apply to accounting periods beginning on or after 1 January 2012 The complementary company law changes came into force on 6 April 2012.

Q3 Can an investment trust which is also an investment company still pay dividends out of revenue profits even if it has capital losses?

Yes, there have been no changes to this part of company law.

Q4 What is the tax treatment of dividends paid out of capital profits?

The dividends are taxed in the same way as a normal dividend. The table below summarises the effective rates of tax that are paid for the main groups of shareholder:

Shareholder	***Dividend***	***Return of Capital***
Non-tax payers, e.g. ISA holders, pension funds, charities	*No tax payable*	*No tax payable*
Basic rate tax payers	*No further tax payable*	*18% tax on gain**
Higher rate tax payers	*25% tax on cash dividend*	*28% tax on gain**
Additional rate tax payers (50% rate until 6th April 2013)	*36.11% tax on cash dividend*	*28% tax on gain**
Additional rate tax payers (45% rate from 6th April 2013)	*30.56% tax on cash dividend*	*28% tax on gain**
Corporate shareholders	*Generally exempt*	*Corporation tax payable*

**unless within annual exempt amount or can offset losses*

Q5 Should a company remove the prohibition from its Articles even if it does not currently intend, or is not able, to distribute capital profits?

The AIC believes that companies should consider removing the prohibition (most likely at the next AGM) even if they do not intend to make use of this flexibility.

If a company were later to decide that it wanted to take advantage of the new rules or, alternatively, a company were required (see Q8 below) to make a distribution out of capital profits, this would avoid the possible time and expense to convene an additional meeting.

Q6 Is shareholder approval required?

An amendment to an investment trust's Articles of Association to remove the prohibition on the distribution of capital profits by way of dividend would require a special resolution of shareholders.

Q7 Does the company need to calculate realised capital profits in order to pay such dividends?

Yes, a company will need to satisfy itself that it has sufficient realised capital profits in order to pay such a dividend. The calculation will be the same as is already required if a company uses capital profits for a share buy-back.

The Institute of Chartered Accountants in England and Wales and of Scotland has issued **guidance** on the Determination of Realised Profits and Losses in the Context of Distributions under the Companies Act 2006 (Tech 02/10).

Q8 Will a company ever be required to pay a dividend out of capital profits?

In most cases, the decision to pay a dividend out of capital profits will simply be a commercial one for the Board to take.

However, where an investment trust has investments in certain types of offshore fund, it may be required to pay a dividend out of capital profits (see the **detailed technical note**, section 5.2.3 page 9, for more information). Note: HMRC will not accept that a prohibition on the distribution of capital profits in the Articles will frustrate the operation of this provision.

In addition, where an investment trust has a large accumulated deficit on reserve reserves, but also capital profits, and then generates a revenue profit in the current year it would appear, under the tax regulations, that the company may be required to make a distribution where it would not have previously been required to do so. The AIC is exploring this further with HMRC and will provide further guidance in due course.

May 2012

If you have any questions regarding the issues raised in this paper please contact:

Janette Sawden - Tax Adviser, AIC Tel: 0207 282 5565 Email: janette.sawden@theaic.co.uk