CHAPTER 17

BUSINESSES AND THE SETTLEMENTS LEGISLATION

17.1 Background

The provisions of s.624 ITTOIA 2005 (and its predecessors) were originally introduced to prevent the settlor of a trust gaining a tax advantage in situations where he (or his spouse) could benefit from a trust.

In recent years, HMRC has been seeking to extend the settlements anti-avoidance legislation to business situations.

HMRC guidance in this area was published in the February 2004 Tax Bulletin (reproduced as RI 268 in Volume 2 of the Tolley Yellow Tax Handbooks). You should be aware that the Tax Bulletin was issued before the enactment of ITTOIA 2005, so statutory references to the anti-avoidance rules within the Bulletin are to the former legislation, which was s.660A ICTA 1988.

17.2 Definition of a "settlement"

The word **"settlement" has a much wider meaning than the word "trust"**, and a settlement" can encompass situations where a transfer of income or assets has been made without the legal formalities of a trust. A "settlement" is defined within s.620 ITTOIA 2005 as any…

".. disposition, trust, covenant, agreement, arrangement or transfer of assets…".

Therefore a **simple transfer of assets between persons** could be regarded as an "arrangement" falling within s.620 and thereby falling foul of the "settlements" legislation, in particular s.624, if either the settlor or spouse can benefit from the property transferred.

Case law has established that a "settlement" can only be created where there is an **element of "bounty"** between the parties. Therefore the settlor must agree to confer a benefit of some sort on the recipient for there to be a settlement. If the transfer of assets is part of a **commercial arrangement** and the settlor has **no gratuitous intent** when making the transfer, there is **no element of bounty and therefore no "settlement".**

17.3 Application to businesses

HMRC takes issue with arrangements under which an individual seeks to **divert income to members of his family**. Typically such family members will be spouses/civil partners and/or children who pay income tax at a lower marginal rate than the individual himself. Such "arrangements" typically involve a partnership or family company where profits are "spread" among family members so as to reduce the overall tax liability.

For example, assume a small company is run by Mr Jones. Mr Jones has the technical expertise and this generates the profits of the company. Mr Jones has 50% of the shares. Mrs Jones (his wife) has the other 50%, but has no technical expertise in the business area and does not assist in generating income. Profits are distributed via dividends.

HMRC has said that:

"… a good test of whether or not the legislation could apply is to consider **"would the same payments be made to a person who acquired shares in the company at arm's length",** or is income being paid simply because the recipient is your spouse or child or some other individual you might wish to benefit".

In the above scenario, HMRC has been arguing that the establishment of a company with a spouse as shareholder is an "arrangement" within s.620. This is a "bounteous" arrangement, as the settlor (Mr Jones) is seeking to confer a benefit on the recipient (Mrs Jones) by diverting dividends to her to use personal allowances and lower / basic rate bands. In a business situation, Mr Jones **would not have allowed an unconnected third party to subscribe for 50% of the shares in his company (and thereafter be entitled to 50% of the profits) without that third party bringing in technical expertise and an ability to generate income.** He has only allowed this to happen because the other shareholder is a member of his family whom he wishes to benefit from the arrangement.

In this scenario, HMRC has been arguing that a "settlement" has been created from which the spouse can benefit. S.624 will therefore apply to tax the spouse's income in the hands of the settlor / husband.

17.4 Exception for outright gifts

Under s.626 ITTOIA 2005, s.624 **does not apply to an outright gift** of assets between spouses/civil partners provided that:

a) the gift is **unconditional;**
b) the gift **carries a right to the whole of the income**; and
c) the gifted property is **not substantially a right to income**.

Therefore, tax planning whereby a husband gifts, say, a rental property to his wife to ensure that the rental profits are taxed in his wife's name and uses her personal allowances etc, is still bona fide tax planning and will not be caught by s.624. However this will only be the case if the gift is outright and unconditional (i.e. the wife is free to use the income and/or dispose of the property as she sees fit).

In *Young v Pearce (1996)*, the directors of a company (Mr Pearce and Mr Scrutton) equally owned the ordinary voting shares. They subsequently arranged for preference shares in the company to be issued to their wives. Their wives did not work for the company. The company then declared substantial dividends to the holders of the preference shares. HMRC argued that the transactions amounted to "arrangements" and hence constituted a settlement in which the settlors and their spouses had an interest. As a consequence, the income distributed to the wives as preference shareholders should be charged to tax in the hands of their husbands as settlors.

The Courts agreed with HMRC. In this instance, the gift of preference shares to the wives was a gift of "wholly or substantially a right to income" and therefore the exclusion in s.626 ITTOIA 2005 did not apply. The preference shares did not carry voting rights and had no value. They were simply issued as a conduit through which to divert the income of the higher-rate tax-paying husbands to their lower-rate tax-paying spouses.

17.5 Other situations caught by s.624

Partnerships between spouses

If spouses are in partnership and one of the partners receives a **disproportionate return** on their contribution simply because they are a family member, s.624 could apply.

Illustration 1

Mr Doshi is a self-employed dentist. He has annual trading profits of £100,000. Mrs Doshi (his wife) works as a part time receptionist in the dental surgery earning £8,000 per annum.

This is a normal commercial arrangement and is not attacked by HMRC. Mrs Doshi's salary uses up her personal allowances and some of her basic rate band. Her salary is deductible in computing Mr Doshi's trading profits (most of which are taxed at 40%).

Illustration 2

Mr and Mrs Doshi are advised to establish a partnership whereby profits are split 50:50. This will enable some of Mr Doshi's profits to be diverted to his wife to use the rest of her basic rate band (rather than these profits being taxed on Mr Doshi at 40%).

It is likely here that HMRC would attack this as a "bounteous arrangement" falling within s.624. Mr Doshi would not, in a commercial situation, allow a part-time receptionist in his business to have a 50% partnership share. Mrs Doshi's partnership profits would therefore be taxed on Mr Doshi as the settlor.

If a husband and wife partnership route were to be pursued in this instance, the partners would be advised to split profits (say) 90:10 to more accurately reflect each partners' commercial input. Whilst this may escape attack under s.624, it wouldn't save much tax as Mr Doshi's profits are still largely taxable at 40%!

Gifts of shares to children

Illustration 3

Mr Collis is a self-employed property surveyor. He sets up a new company and subscribes £1 for one share. His 15-year-old daughter Lucy also subscribes £1 for one share. These are the only shares in issue. Lucy works for the new company as an administration assistant during school holidays and at weekends. She is paid £4,000 per annum.

Lucy's salary is commensurate for the work she carries out for Mr Collis, so this is unlikely to be attacked by HMRC as being bounteous and non-commercial. Lucy's salary will be covered by her personal allowances.

However, if the company declares a dividend, 50% of which is paid to Lucy, this will be challenged as a "bounteous arrangement". As Lucy is a minor child who is unmarried and not in a civil partnership of Mr Collis, this arrangement will be treated as a parental settlement and the dividend paid to Lucy will be taxed on Mr Collis under s.629.

Other examples of business situations where the settlement rules would be applied are given at RI 268 in Volume 2 of the Tolley Yellow Tax Handbooks.

17.6 Arctic Systems Ltd

HMRC's approach in applying the settlements legislation to businesses was tested in the case of *Jones v Garnett.* The facts in this case are straightforward and very common.

Mr Jones was an IT Consultant. He ran his own computer consultancy business via a limited company called Arctic Systems Ltd. He traded via a limited company as his clients wanted to ensure they were not classed as "employers" and would therefore only engage his services through a company (i.e. he established the company for bona fide commercial reasons rather than to reduce tax liabilities).

The company had an issued share capital of £2. Mr Jones had subscribed for one £1 share. Mrs Jones (his wife) had subscribed for the other £1 share.

Mr Jones was the sole director (although he did not have a formal service contract) and his expertise generated the income of the company. He drew a small salary in return for working full-time

Mrs Jones was the company secretary. She carried out administrative work such as invoicing and bookkeeping. She worked, on average, about 5 hours a week for which she was paid a modest salary. The balance of any profits was distributed to Mr and Mrs Jones by way of dividends. The dividends were decided upon by Mr Jones in his capacity as director.

HMRC argued that this was a bounteous arrangement and that the settlement rules should be applied to the dividends paid to Mrs Jones. As such, these dividends should be taxed on Mr Jones. The taxpayers appealed and the case was heard by the Special Commissioners.

Special Commissioners decision

The two Special Commissioners could not come to an agreement, so the presiding Commissioner had the casting vote. She found in favour of HMRC. Mr Jones subsequently appealed to the High Court.

High Court decision

The High Court also found in favour of HMRC on the basis that:

1. there **was** an "arrangement" under the provisions of s.620; and
2. the exclusion for "outright gifts to spouses" in s.626 did **not** apply.

Taking each in turn:

"Arrangement"

The Court decided that the reason behind Mrs Jones holding one share in Arctic Systems Ltd, was solely to be able to benefit from any dividends declared by the company. The Judge described Mrs Jones' share in the company as "a means through which bounty will or may be channelled…". As such there was an arrangement which was bounteous and s.624 could be applied.

The "arrangement" was that Mr and Mrs Jones subscribed £1 each for their shares, Mr Jones would work full time for a small salary and any remaining profits would be paid as dividends. The fact that there was no contractual agreement was irrelevant. The above still constituted an "arrangement" within s.620.

Mr Jones is treated as the settlor in this scenario because, by working full-time and failing to draw a commercial salary, he provided funds for the settlement from which he and his wife could benefit. S.624 ITTOIA 2005 therefore applied.

If Mr Jones had drawn a salary commensurate with his commercial earning power, it would have been more difficult for HMRC to argue that a "settlement" had been created.

S.626 ITTOIA 2005

The Court rejected the taxpayers' claim that Mrs Jones obtained her share as a result of an outright gift from her husband (and therefore that s.626 applied to exclude the arrangement from falling within s.624).

Mrs Jones bought her share for £1. It was not given to her by her husband. As there was no inter-spouse gift, s.626 could not apply

Even if a gift had taken place (for instance, if Mr Jones had subscribed for both shares then given a share to his spouse), the Judge remained unconvinced that this would have been an "outright" gift of a share as the gift was only one part of the whole arrangement.

Mr Jones subsequently appealed to the Court of Appeal.

Court of Appeal decision

The Court allowed appeal and found in favour of Mr Jones. It ruled that the dividends paid to Mrs Jones did not fall within s.624 as there was no "arrangement" within s.620.

The salary paid to Mr Jones and the payment of dividends did not form part of a "structure". They were uncertain and fluid and as such were the opposite of an "arrangement" within s.620. Without these elements there was no element of bounty and no "settlement" within the statutory definition.

As there was no settlement, there was therefore no need for the Court to consider whether there was an outright gift. However, if this had been in point, the Court expressed the view that there had been no outright gift, agreeing with the views expressed in the High Court

House of Lords decision (June 2007)

The case was heard in the House of Lords in June 2007.

The **Lords found in favour of the taxpayer** and dismissed HMRC's appeal.

The Lords concluded that:

1) There **WAS** an arrangement in the nature of a settlement when the Jones's subscribed £1 each for their shares in Arctic Systems Ltd. S.624 ITTOIA 2005 was therefore in point.

   However:

2) The exemption for gifts between spouses in S.626 ITTOIA 2005 applied and any dividends paid by the company to Mrs Jones should **not be treated as income arising under the settlement**. The dividend income should therefore be **taxable in the hands of Mrs Jones** and not be attributed to her husband as settlor.

HMRC are planning to enact legislation to counter income shifting. It was originally intended that this would be included in Finance Act 2008. However, this legislation has been delayed and will now be included in a later Finance Act.

17.7 After Jones v Garnett

It does not necessarily follow that the decision in *Jones v Garnett* should be applied to all companies where spouses are shareholders. There seem to be a number of ways to structure a company to avoid falling foul of the settlement rules.

1. Ensure **both spouses play an active part**. If a company is run jointly by both spouses and both contribute to making decisions and earning profits, the settlements legislation is unlikely to apply.

2. If **one spouse is more active than the other** in running the business (as in Arctic Systems), ensure the **"active" spouse is paid a "market" wage**.

3. **Structure the shareholdings to reflect the input of the spouses/civil partners**. For example, holding shares 90:10 is less likely to provoke an HMRC challenge.

4. **Keep the structure fluid.** Following the Court of Appeal decision, it seems that if the structure used is fluid and uncertain, it will not form an "arrangement" within s.624.

Finally be aware that HMRC's views as expressed in the Tax Bulletin are merely statements as to how they see the law and how they will apply it in certain situations. The Tax Bulletin is not law and it is open for a taxpayer to take a different view and submit self-assessment returns on that basis.

If the taxpayer decides to take a different stance, he should clearly indicate his position within the return. In so doing, the taxpayer is likely to be protected from HMRC raising discovery assessments once the formal enquiry window has closed.