

S660A SETTLEMENTS LEGISLATION

The Guidance in this document has been superseded by our publications on Income Shifting. Its retained here for reference only.

(August 2007 – post High Court hearing)

In July the High Court confirmed the Court of Appeal ruling. At present the law is still in the taxpayers favour and spousal dividends are permitted in most circumstances, but legislation is expected in due course.

(December 2005 – post Arctic Systems appeal in Court of Appeal)

Shortly after our May 2005 guidance was published, an appeal was announced against the High Court decision.

The Court of Appeal published its judgement on 15 December 2005, and overturned the previous decisions at the Special Commissioners and High Court.

This currently puts the law back to how the accountancy and tax profession had understood it to be for the last century or so – up to 2003 – which was that issuing / gifting ordinary shares in a company, by itself, did not represent a settlement.

The most common example of this – and the one effected by the Arctic Systems facts – is shares in a family company being owned jointly by husband and wife, even if one of their contributions to the business are unequal.

So, for now, spousal shareholdings are allowed again, with their attendant tax savings (in this context spouse includes common law and civil partnership arrangements).

The Court of Appeals judgement is through and unambiguous, but HMRC/Government have the possibility of appealing to the House of Lords or enacting legislation in the next finance act. In his opinion, Lord Justice Carnwath, one of the judges said, “... *If the legislature wishes such an arrangement to be brought within a special regime for tax purposes, clearer language is necessary to achieve it.*”

Practical strategies:

- On HMRCs original, now overruled interpretations, see the guidance below, only a minority of companies were effected – the key criteria being (i) shares being distributed in a manner disproportionate to involvement and (ii) the company not having substantial assets. Leg (ii) means many, indeed most, family companies would not have been effected (contrary to press reports at the time). The prime candidate for being effected by the legislation would have been so called “personal service companies” (PSCs) – companies which largely exist to sell the services of one person.

- for now its sensible for all PSCs to revert / initiate spousal shareholdings.

- there may be further developments during 2006 dependant on any further court action and/or legislation (at the time of writing HMRC have announced a decision to appeal, but the date of the appeal is not set).

S660A SETTLEMENTS LEGISLATION - continued **(May 2005 – post Arctic Systems appeal in High Court)**

S660A ICTA 1988, known as the settlements legislation, is intended to counter perceived tax benefits from giving away income streams to others.

The section has been on the statute book since the early 1900s, but to date has been very rarely invoked by H M Revenue & Customs. In early 2003 this changed – although the change was initially unpublished – as rumours started to circulate in early 2003 of the clause being invoked and large back tax bills being levied.

A test case (Arctic Systems) went before the Special Commissioners (a tax equivalent of a Magistrates Court), and then on to appeal. Both the Special Commissioners hearing and the subsequent appeal were won by H M Revenue & Customs.

Who is effected? Potentially any situation of a family company (including common law relationships and relatives other than spouses) where shares have been distributed in a manner disproportionate to involvement in the company, and where the company does not have substantial assets.

Some practical examples are given later in this document.

The details H M Revenue & Customs state that the settlements legislation is “*intended to prevent an individual from gaining a tax advantage by making arrangements which divert his or her income to another person who is liable at a lower rate of tax or is not liable to income tax*” (IR Tax Bulletin 64-April 2003)

It therefore is only applicable where income is diverted. As a matter of law – and H M Revenue & Customs and the Tax Profession agree on this – where an asset is given away on a genuine basis then the income stream arises from the asset and not from a diversionary tactic, and the settlements legislation cannot apply.

What has brought this issue to prominence recently is that H M Revenue & Customs view on what constitutes a genuine gift of an asset (OK) and what is a diversionary tactic (not OK) has changed. Or at least seemingly has changed, as there was initially no public announcement, no new case law and no new statutes. After the issue started bubbling in Spring 2003 some guidance was published in the IR Tax Bulletin 64 (<http://www.hmrc.gov.uk/bulletins/tb64.htm>) but this does not mention any change in H M Revenue & Customs policy – without exception this was been condemned as devious by the Tax Profession – no change in legislation, no new case law, no new guidance until pushed – just a decision to enforce the rules differently!

The analysis by H M Revenue & Customs in Tax Bulletin 64 was disputed by the Tax Profession, including leading Tax Counsel. Sadly the Courts have upheld H M Revenue & Customs interpretations.

Practicalities of who is effected In practical terms those effected are situations where a company’s revenue is largely derived from the intellectual capital of one of its shareholders, but other shareholders benefit. A partnership situation can also be caught. The other shareholders will normally be related, eg husband and wife (including common law), or other family connections.

S660A SETTLEMENTS LEGISLATION - continued
(May 2005 – post Arctic Systems appeal)

The Arctic systems test case concerned a situation, which many reading this will recognise, of a Husband and Wife with a personal service company. Husband is an IT consultant and brought in all the company's revenue, and his wife carried out administration and bookkeeping for the company. They each drew low salaries and the remainder of the company profits as joint dividends. HM Revenue & Customs alleged that this was a settlement by husband on wife (a form of trust), and as such the income (dividends) were taxable on him. The Court agreed.

The Court also went on to say that not all husband and wife businesses are caught in this way, the judge specifically stating "*If a husband and wife set up a joint company and run it together, for example the company opens a shop and the couple run and staff it, it does not follow from my judgement in this case that the husband is going to be taxed on the wife's dividend.*"

So, what situations are caught and what are potentially acceptable. The following extract from HMRC Tax Bulletin 69 (February 2004) is probably a clear example of how HMRC see the rules working:

Example 5 - Partnerships *Mr F and Mr G are in partnership as second hand car dealers. They do not have any premises but buy and sell cars through auctions and the classified adverts of local papers. The partnership's only assets are some office equipment worth less than £1,000 and they usually have a couple of cars in stock at any one time. They are successful and the profits of £80,000 a year are split equally between them. They decide to admit their wives to the partnership and amend the partnership agreement in order to split profits equally four ways. Mrs F and Mrs G do no work in the partnership and the partnership has no employees. This is a bounteous arrangement transferring income from one spouse to the other. The settlements legislation will apply and Mr F and Mr G continue to be taxable on half the profits each.*

But compare to:

Example 22 *Mr Alpha and Mr Beta are in partnership as second hand car dealers. They own the freehold premises through which the partnership trades (valued at £200,000) and routinely carry a stock of 50 used cars. The business is successful and has established goodwill in the locality as a reliable trader. It employs a number of salesmen and office staff. Profits of £100,000 a year are split equally between the partners. They decide to admit their wives to the partnership and amend the partnership agreement in order to split profits and capital equally four ways. Mrs Alpha and Mrs Beta do no work in the partnership. Although this is a bounteous transaction it is an outright gift that is not substantially a right to income and is excluded from the definition of settlement by section 660A(6).*

Put simply if any of the following traits are present, then its unlikely that the settlements legislation will apply:

- an active involvement in the business by the spouse (eg both spouses carrying out work and generating similar amounts of income); or
- substantial assets and/or business structure; or
- investment in the business, or provision of security, eg allowing family home to be used as collateral for a loan, by the spouse

S660A SETTLEMENTS LEGISLATION - continued **(May 2005 – post Arctic Systems appeal)**

If the following traits are present, then it is likely the settlements legislation will apply:

- a company with high income and relatively low expenses and capital base; and
- one spouse having a far more active involvement in the business than the other; and
- the company income being largely derived from the skills of the main shareholder

Commercial remuneration – During the Arctic Systems appeal the Judge also made reference to the 'market salary'. He said: *"It is also an important feature of this case that Mr Jones provided funds directly or indirectly for the purpose of the 'settlement' by working for Arctic Systems in return for a salary below his true earning power."* He went on to say *"It will be far harder for the Revenue to establish that there is a 'settlement' or 'arrangement' of which the husband is the 'settler' if he is paid the going rate for employees carrying out the sort of work which he does."*

The immediate response to this is increase the main shareholders salary to a so called "commercial" level. Alas its not so simple as this – meet, Reg, Jane and Frank...

Reg is an IT consultant, operating via a PSC. He is married to Jane who does his books and administers his business. Reg is currently on contract at Mega Bank, and sits next to Frank who does the same type of work as Reg but as permanent staff (ignore the fact this is disastrous for Reg's IR35 status). Frank is on a salary of £60,000 pa, whereas Reg invoices £2,000 per week before vat.

Currently Reg and Jane have taken their accountants advice, and pay themselves a small salary and draw the rest of the company profits as dividend on a 50:50 split.

They decide post the Arctic Systems judgement that Reg should take a commercial salary, and seek their accountants advice. Their accountant scratches her head and says, "Well, depends on what you mean as 'commercial'...". Why the uncertainty – isn't Frank a good comparator as a commercial salary level? Well, maybe, but there are a number of options for commercial salary:

- The salary which an equivalent permanent member of staff earns, in this case £60,000; or
- The salary which an equivalent IT contractor who is director of his own company earns – say £8,000 pa average (why? – most, if not all, well advised contractors have been taking low salary and high dividend).
- A salary which represents substantially all of Franks contract earnings, less, say, 5% for expenses and Employers NI (hang on, anyone recognise this as IR35 by the back door?)

The point is Reg and Frank may do a similar type of work, but their circumstances are different. Frank has security of employment, Reg doesn't. Reg has his own company any the ability to offset expenses, take on other work, has to provide his own training, equipment and insurance, Frank doesn't.

So, in fact, its very unclear exactly what the "commercial salary" would be for Reg.

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(May 2005 – post Arctic Systems appeal)

Lets put some figures on things:

Frank	<u>Permanent employment, £60,000 pa</u>	
	Takes home	£40,343
	Total tax and NI (employers and employees)	£26,681

Reg	<u>As he is now</u>	
	Contract income (say 46 weeks pa) £92,000, less expenses of, say, 5%, = £87,400	
	Salary Reg £8,000, Jane £4,600	
	Dividend (net) £60,265, split 50:50	
	Corporation Tax	£14,136
	PAYE/NI	£1,174
	Personal Tax	£1,119
	Total tax	£16,429
	Take home	£70,971

Decides to take Jane off as a shareholder, leave salaries unchanged

	Contract income (say 46 weeks pa) £92,000, less expenses of, say, 5%, = £87,400	
	Salary Reg £8,000, Jane £4,600	
	Dividend (net) £60,265, all to Reg	
	Corporation Tax	£14,136
	PAYE/NI	£1,174
	Personal Tax	£8,475
	Total tax	£23,785
	Take home	£63,615
	Worse off compared to now by	£7,356

S660A SETTLEMENTS LEGISLATION - continued
(May 2005 – post Arctic Systems appeal)

Reg continued (2 of 4)

Decides commercial salary is £60,000 pa

Contract income (say 46 weeks pa) £92,000, less expenses
 of, say, 5%, = £87,400

Salary Reg £60,000, Jane £4,600
 Dividend (net) £13,034, split 50:50

Corporation Tax	£2,711
PAYE/NI	£26,681
Personal Tax	£1,629
Total tax	£31,021
Take home	£56,379
Worse off compared to now by	£14,592

Decides commercial salary is £60,000 pa, but HMRC say this
 isn't enough and assess Janes Dividends to him

Contract income (say 46 weeks pa) £92,000, less expenses
 of, say, 5%, = £87,400

Salary Reg £60,000, Jane £4,600
 Dividend (net) £13,034, all to Reg

Corporation Tax	£2,711
PAYE/NI	£26,681
Personal Tax	£3,259
Total tax	£32,651
Take home	£54,749
Worse off compared to now by	£16,222

S660A SETTLEMENTS LEGISLATION - continued
(May 2005 – post Arctic Systems appeal)

Reg continued (3 of 4)

Decides commercial salary is £40,000 pa

Contract income (say 46 weeks pa) £92,000, less expenses
of, say, 5%, = £87,400

Salary Reg £40,000, Jane £4,600
Dividend (net) £31,132, split 50:50

Corporation Tax	£7,174
PAYE/NI	£15,921
Personal Tax	£3,892
Total tax	£26,987
Take home	£60,413
Worse off compared to now by	£10,558

Decides commercial salary is £40,000 pa, but HMRC say this
isn't enough and assess Janes Dividends to him

Contract income (say 46 weeks pa) £92,000, less expenses
of, say, 5%, = £87,400

Salary Reg £40,000, Jane £4,600
Dividend (net) £31,132 all to Reg

Corporation Tax	£7,174
PAYE/NI	£15,921
Personal Tax	£7,783
Total tax	£30,878
Take home	£56,522
Worse off compared to now by	£14,449

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(May 2005 – post Arctic Systems appeal)

Reg continued (4 of 4)

<u>Summary for Reg</u>	Tax PA £	Worse off by £
Tax PA as he is now	£16,429	
Tax PA taking Jane off as shareholder	£23,785	£7,356
Salary of £60k pa, dividend 50:50	£31,021	£14,592
Salary of £60k pa, dividend 100% following HMRC assessment	£32,651	£16,222
Salary of £40k pa, dividend 50:50	£26,987	£10,558
Salary of £40k pa, dividend 100% following HMRC assessment	£30,878	£14,449

So, in summary, the best option for Reg is to ignore the temptation to pay a “commercial salary” and simply take his wife off as a shareholder. Even if HMRC accept his assertions about “commercial salary”, he is best off keeping salaries low and forgoing spousal dividends, and if they don’t accept his assertions then he is even worse off.

Drop the dividends and keep the spouse salary? – In all probability this is a safe option. In many parts of the country £10 per hour isn’t an unreasonable hourly rate for a bookkeeper / secretary / PA, and if the spouse salary is set to Personal Allowance level of £4,800 pa then this equates to 10 hours a week/48 weeks a year – a bit high for doing the books/raising an invoice/answering the phone/trawling jobserve, but probably not so far off for HMRC to challenge it.

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