Jointly owned shares in close companies

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At the time of the 2004 Budget the Government announced that "a measure will be introduced, with effect from 6 April 2004, to tax distributions (including dividends) from shares in close companies jointly owned by a husband and wife, according to the actual proportions of ownership and entitlement to the income."[1] At present where a married couple hold property in their joint names, the standard rule with regards to investment income is that it is split equally between each spouse for tax purposes (the '50-50 rule'). In certain circumstances a couple can make a 'declaration' together, should they wish to be taxed on their actual entitlement to income from this property.

In recent months there has been some concern about the Inland Revenue taking a sterner approach with regards to tax planning by family-owned companies: in particular, the application of section 660 of the *Income and Corporation Taxes Act* (*ICTA) 1988* – the 'settlements legislation' as it is commonly known – to the transfer of shares in a family business between spouses. This note looks first at the general rules regarding jointly owned property, and the debate about s.660 of *ICTA 1988*, before looking at this measure in detail.

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A. Jointly owned property: the current rules

At present where a married couple hold property in their joint names, the standard rule with regards to investment income is that it is split equally between each spouse for tax purposes (the '50-50 rule').[2] In certain circumstances a couple can make a 'declaration' together, should they wish to be taxed on their actual entitlement to income from this property.[3] For this purpose couples may complete Form 17 (Joint property and income) for the Inland

1 *Budget 2004* HC 301 March 2004 p 200. Broadly speaking, close companies are "small companies owned and run by five or fewer people" (Inland Revenue Budget Note REV BN 22, 17 March 2004).
2 under section 282A of the *Income and Corporation Taxes Act (ICTA) 1988*
3 under section 282B of *ICTA 1988*

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Revenue.[4] Guidance on the 50-50 rule is given in the Inland Revenue's *Independent Taxation Manual*, from which a short extract is reproduced below:

> **Jointly held property and income: special rules**
> A married couple who live together may hold property in their joint names. In this guidance the terms 'property' and 'assets' mean the same thing. They mean the form of investment i.e. actual property (land and buildings), stocks and shares, bank and building society accounts etc. There are two rules about such jointly held property:
> - the standard rule is that investment income … from jointly held property is split equally between each spouse for tax purposes …
> - where the true split is different the couple can opt to be taxed on that basis …
>
> **ICTA88 S282A 50:50 rule**
> Investment income from property held in joint names is split 50:50 when a married couple live together. The 50:50 rule does not apply:
> - Where the income is earned income or unearned Case I or II partnership income …
> - where a married couple are separated for tax purposes; in that case you tax a separated spouse's income on their actual entitlement …
> - where property is held in the name of only one spouse even if the other has an interest; there will be a trust and the split follows the entitlement of each spouse to the income …
> - where a husband and wife are entitled to property and the income from it, but the property is held in the name of a nominee (for example a bank). In these circumstances the split of the income follows the entitlement of each spouse to the income:
>   - where neither spouse is entitled to any income from the property; for example, where they hold it as trustees so that
>   - the income belongs to the beneficiaries of the trust, and
>   - neither spouse is a beneficiary.
> - where the couple do not hold 50:50 shares in the income and the capital and they want to be assessed on their actual entitlement …
> - where some other legislation has provided a different split; for example, the Settlements legislation in Part XV ICTA 1988 may provide another allocation.[5]

The Revenue's Manual also gives guidance on the process of making a 'declaration':

> **ICTA88 S282B Declarations: option for split on actual entitlement**
> A married couple can, in certain circumstances, ask to be taxed on their actual entitlement to income from jointly held property. They do this by making what the law calls a 'declaration'. This sets out their actual entitlement. They can only make a

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[4] At present this is on the Revenue's site at: http://www.inlandrevenue.gov.uk/pdfs/form17.pdf

[5] Inland Revenue, *Independent Taxation Manual – INCONT*, paras IN116, IN125. The Manual is published at: http://www.inlandrevenue.gov.uk/manuals/inmanual/html/1incont/01_0001_INCONT.htm

declaration jointly. If one spouse does not want to make a declaration both must accept the standard 50:50 split for jointly held property …

Declaration must reflect reality
A married couple do not have a general option to have income taxed in any way they like. They can only depart from the standard 50:50 split for tax purposes where:

- each spouse is in fact entitled to a share other than 50:50 in the property, and
- the share that a spouse has in the income is the same as their share in the property.

Where both conditions are met the couple can make a declaration to this effect. They are then taxed on their actual entitlements … You should not normally try to verify what the couple tell you about their interests in property. The exception is where they claim to hold bank or building society accounts in unequal shares …

A declaration cannot be made where property is in the joint ownership of a husband or wife, see IN126 [see below]. In these circumstances the couple do not own the property in shares at all, but are each entitled to the whole of both the property and the income. Where the property is in joint ownership, the standard 50:50 split applies even if, for example, the husband has a 90% interest in the capital and a 10% interest in the income, with the wife holding the other 10% and 90% respectively.[6]

On the wider question of joint ownership, the Manual comments as follows:

Beneficial interest, common ownership and joint ownership
The concept of having a beneficial interest in property is a feature of the law of England and Wales. In broad terms a person has a beneficial interest in property and its income when he or she has the right to use that property and that income as he or she wishes. In such circumstances he or she is said to be beneficially entitled to the property and the income. Where property is in the joint names of a husband and wife the determination of their beneficial interests under general law can be very complex. You should not try to advise a husband and wife how to determine their beneficial interests in property that they hold jointly. But the following information may be helpful in responding to general questions from taxpayers.

Property in joint names may be held in two ways:

- in common ownership (in England and Wales the owners will often be called tenants in common)
- in joint ownership (in England and Wales the owners will often be called joint tenants).

Scots law does not recognise the concept of beneficial ownership in the context of jointly held property. But it does recognise the concepts of common ownership and joint ownership of property.

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[6] *op.cit.* paras IN140, IN143

> A husband and wife own property as tenants in common if each is entitled to a separate and identifiable share in the property. The shares in which the property is owned need not be equal. And the ownership of the capital may differ from each spouse's entitlement to a share in the income. For example, a husband could own 60 per cent of the capital but be entitled to only 40 per cent of the income. On the death of the first common owner their share passes to their successor under the terms of their will or the rules of intestacy.
>
> Property is in joint ownership where both the husband and wife are entitled jointly to the whole of the funds invested in the property and the income arising from it. There will be no division of either the capital or the income between husband and wife. It will be irrelevant who has contributed the most to the funds representing the property. Where one of the joint tenants dies the survivor automatically succeeds to sole ownership of the whole property. The most common types of income-producing property held in joint ownership are bank accounts and building society accounts.[7]

Since the introduction of income tax in 1799, a married woman's income has been treated as simply part of her husband's total earnings, and taxed as such. It was only in 1990, with the introduction of independent taxation, that this principle was overturned: all individuals became responsible for their own tax affairs, and married couples were assessed for income tax and capital gains tax as separate persons.[8]

The then Chancellor Nigel Lawson announced this reform in his Budget speech in 1988: the new system would come in "at the earliest practicable date, April 1990" and to this end "the necessary legislation will be contained in this year's Finance Bill."[9] Provisions for taxing husband and wife on income from property held in their joint names – the 50-50 rule – were part of the new system.[10] At the Committee stage of the Finance Bill that year the then Financial Secretary, Norman Lamont, explained the purpose of the new rule:

> The basic rule is very simple and straightforward. It provides for such income to be treated as split between the partners in equal shares so that each will be taxed on half of it. Very many married couples have income form assets which they hold in their joint names. The most common example is interest from joint bank and building society accounts. Under independent taxation it is necessary to determine how the income from such assets should be divided between a husband and wife. In principle this depends on establishing the entitlement of each of the partners to the income and that means determining the beneficial ownership of the assets as distinct from their legal ownership, but that is much more easily said than done. The general law relating to property is very complex … property may be held in many different ways.
>
> In order to establish the entitlements of the partners to the income and property held in their joint names it would be necessary to look at the facts in each case and

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7 *op.cit.* para IN126

8 Further details of this reform is given in, *Tax and marriage*, Library Research paper 95/87, 13 July 1995.

9 HC Deb 15 March 1988 cc 997-8

10 section 34 of the *Finance Act 1988*, now incorporated in ss 282A&B of *ICTA 1988*

> establish the intentions of the partners about the beneficial ownership of the asset when it was acquired, or at some later date if there had been a change in their intentions. The basic rule that we are proposing avoids the need for large numbers of married couples to have to establish the basis on which they are entitled to income from jointly owned property.[11]

In September 2003 the Tax Law Review Committee[12] published a report on the tax treatment of married couples in response to the Government's consultation on introducing a civil partnership scheme.[13] The Committee suggested that civil partnerships should be accorded the same tax treatment as married couples, but pointed to an underlying confusion in the approach taken by the tax system to marriage. On the question of jointly owned property, the Committee made the following comments:

> **4.1.3. Jointly held property**
> In the case of unearned income arising from jointly held property of a married couple, the statutory presumption for tax purposes is that they are beneficially entitled to the income in equal shares (unless it is earned income or "sleeping partner" income).[14] Typical examples would be interest on a deposit account, or rent on a let property, in the name of Mr and Mrs Jones. The income arising would be taxed half each. This presumption is only disturbed if husband and wife make a joint declaration that beneficial ownership is not in fact in equal shares.[15]
>
> The problem that this presumption of equal shares in certain types of income is intended to address is a practical one. Establishing the nature of the beneficial interest in the relevant income-producing property is notoriously difficult in the case of cohabiting couples, and is clearly related to the widespread misconception, noted in the consultative document, that there is in England and Wales a status of "common law marriage" that entitles cohabitees to a share in beneficial ownership of assets legally owned by the other partner after a certain period of time. Typically, one partner has legal ownership but the other makes contributions, directly or indirectly, to the acquisition of the property which create a beneficial interest either under a resulting or constructive trust (or by way of proprietary estoppel).
>
> In the case of married couples the court would more readily expect income arising from such property to be shared between the parties, and the divorce courts have virtually unfettered discretion in adjusting the shares in the property or in compensating one party for lost income. So the presumption for tax purposes that beneficial ownership is equally shared does not seem unreasonable.

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11 SC Deb (A) 26 May 1988 c 281

12 The Committee was set up by the Institute for Fiscal Studies in autumn 1994 to ask whether the tax system was working as intended, efficiently and without imposing unnecessary burdens. Further information on its work is available on the IFS internet site at: http://www1.ifs.org.uk/taxlawindex.shtml

13 Legislation is now before the House to introduce civil partnerships. For details see *The Civil Partnership Bill*, Library Research paper 04/64, 7 September 2004.

14 *ICTA 1988*, section 282A.

15 Provided for in *ICTA 1988*, section 282B.

> Two kinds of problem may then arise for married couples. The first is when the couple are separated, or perhaps still living together, and cooperation to make (or maintain) a joint declaration cannot be secured. Then the equal shares rule applies for tax purposes, even though the true beneficial ownership might be quite different and a presumption of equal sharing manifestly unjust to one party.
>
> The second problem arises when the Inland Revenue does not accept the couple's contention as to the division of beneficial interest in the joint property and is able to challenge it by other means. This is currently extremely contentious in the case of dividends from a family owned company, where the wife has received the dividends but the Inland Revenue is intent on taxing the couple as if the husband had received them instead, under the settlements legislation that is referred to … below.[16]
>
> Since this provision, requiring a joint declaration or acceptance of equal shares, does not always work well at present, it seems questionable whether it should be carried over to the case of civil partnerships, other than on the general principle that civil partners should be treated in the same way as married couples and the observation that there are no plans to change this particular provision for the latter. We should however perhaps emphasise that this issue is only relevant for certain types of income. In most cases, particularly in the case of earned income which is excluded from equal shares treatment, it should be clear enough from the facts who is the beneficial owner of the income and should therefore be taxed on it (even if it is routed to some other person in order to take advantage of a lower tax rate).[17]

B. Family businesses and anti-avoidance legislation

In spring 2003 the press reported concerns from several tax practitioners that the Inland Revenue had amended its interpretation of section 660 of *ICTA 1988* – the 'settlements legislation' as it is commonly known – in its application to the transfer of shares in a family business between spouses.[18] These provisions in tax law are established to prevent settlements – generally speaking, a disposition, trust, covenant, agreement, arrangement or transfer of assets – being used to gain tax advantages. Some felt that the Revenue was now taking a 'more aggressive approach' toward a tax planning mechanism whereby the main earner in a family business transferred shares to their spouse, which provide their spouse with dividend income. The purpose of the transaction would be to reduce the main earner's taxable income, diverting part of it through the structure of the family business into their spouse's hands. An extract from one article written at this time is given below:

> It is common for tiny companies to have half-ownership of the shares by husbands and wives. The profits are paid partly as salary and partly as a dividend on the shares.

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[16] This related, if separate, issue is discussed below.

[17] Tax Law Review Committee, *Response to Civil Partnership: a framework for the legal recognition of same-sex couples*, September 2003 pp 9-10. At: http://www1.ifs.org.uk/taxlaw/civil.pdf

[18] "Inland Revenue to make family businesses pay", *Times*, 15 March 2003; "Not for richer, only for poorer", *Daily Telegraph*, 10 March 2003. The issue was also raised in the technical press: "All very unsettling!", *Taxation*, 13 March 2003.

> Paying some of the dividends to the spouse keeping the books and acting as company secretary helps the main earner to reduce income and thus stay out of a higher tax bracket … The Revenue has started operating a section of the Income and Corporation Taxes Act which allows the income to be attributed to the person the taxman decides is doing most of the work. The Revenue's move derives from section 660A of the Act which in effect says transferring an income stream to a relative who does not pay for the privilege is merely a pretence, especially if the donor "maintains an interest". In one recent letter to a small business, the tax inspector said the wife's work as company secretary without pay was only a few hours a week, so half the dividend income she received from her 50pc ownership of the shares would be transferred to the husband. As a result, another £14,000 of tax was due ...
>
> Peter Vaines of Haarman Hammelrath suggested the campaign probably derived from legal cases *Young v Pearce* and *Young v Scrutton [1996]* which the Revenue won, though those were about preference shares. The legislation concerning spouses is when the gift is wholly or substantially a right to income, he explained. As a result, the point is indeed arguable on preference shares, which are in effect entitlements to income, but on ordinary shares "the arguments don't seem very good", he added. Ordinary shares "cannot be said to be wholly or substantially a right to income. The shares represent a bundle of rights and the right to income is not the most important." In addition, unlike preference shares, the dividend is optional. In that case, "the taxpayer would have a very good argument". Francesca Lagerberg of accountancy firm Smith & Williamson agreed that "it doesn't tie in with the spirit of the legislation. The decision may be justifiable on preference shares, but ordinary shares carry duties and responsibilities." …
>
> The legal boundaries of this "settlements" legislation have never been tested, explained John Whiting of Price Waterhouse Coopers, despite being around since the 1930s. In addition, "it is an area that is not well understood". Accountants until now thought the settlements legislation did not apply when the husband gave shares to the wife because that was covered by the exemption in s660A(6) of the Act. "However the Revenue view is that this exemption does not apply because the shares are 'wholly or substantially a right to income'," … [says, Anne Redston of Ernst & Young]. Mr Whiting said owners of small businesses would not have been warned this danger was on the way. There has certainly been no easily available guidance on this, such as tax bulletins or press releases, and no tax cases which deal with the areas under attack. The Revenue has, however, promised to produce guidance on how it now thinks the rules should be applied.[19]

Apropos the last point made in this piece, one practitioner noted elsewhere that "commentators and authors on incorporation have long highlighted the need to be conscious of the settlements legislation when sole traders incorporate and subsequently want to pay dividends to a spouse ….[and] the point has long been addressed in what is now known as the

[19] "Not for richer, only for poorer: running a family business may become even more fraught, thanks to a new stealth tax", *Daily Telegraph*, 10 March 2003

Revenue's trusts, settlements and estates manual."[20] Indeed at the time the Paymaster General, Dawn Primarolo, responded to a written question about this issue simply stating that, "the Inland Revenue has not changed its interpretation of sections 660A to 669 of the *Income and Corporation Taxes Act 1988.*"[21]

Following representation from the Chartered Institute of Taxation (CIOT), the Revenue published a long article in April 2003, looking at situations where, in its view, the settlements legislation applied to non-trust situations involving individuals, companies and partnerships. Its conclusion was as follows:

> Whether or not the settlements legislation applies to an arrangement depends on the particular facts of the case. It is necessary to look at the arrangement as a whole. If there is a bounteous arrangement which effectively transfers income earned by one person to another resulting in a reduction in overall tax liability the arrangement may be liable to challenge under the settlements legislation.
>
> A purely commercial transaction or series of transactions at arms length is outside the meaning of 'settlement'. Most commonly the legislation will apply where individuals seek to divert income to members of their family or to friends. 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 a company or a share of a partnership at arms length. Or whether income is being paid simply because the recipient is your spouse or child or some other individual you might wish to benefit.[22]

Many in the profession were strongly critical of the piece and of the Revenue's approach as a whole, and in September 2003 the CIOT made joint representation to the Revenue with the other accountancy institutes and the Federation of Small Businesses.[23] In their report on civil partnerships cited above, the Tax Law Review Committee made the following comments:

> **4.4. Settlements**
> The concept of a "settlement" in the Taxes Acts is an extended and complex one, with consequences spanning income, capital gains and inheritance taxes. For income tax:
>
> - "settlement" includes any disposition, trust, covenant, agreement, arrangement or transfer of assets, and
> - "settlor", in relation to a settlement, means any person by whom the settlement was made.[24]

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[20] "Why not enforce existing rules", *Accountancy Age*, 3 April 2003. The Manual is published on the Revenue's site at: http://www.inlandrevenue.gov.uk/manuals/tsemmanual/index.htm

[21] HC Deb 27 March 2003 c 341W

[22] "Businesses, Individuals and the Settlements Legislation", *Tax Bulletin*, issue 64 April 2003 pp 1015-6. This publication is on the Revenue's site at: http://www.inlandrevenue.gov.uk/bulletins/index.htm

[23] "Tax attack puts family firms in jeopardy", *Guardian*, 11 September 2003. For a contrary view of the position see, "The Revenue is right", *Tax Journal*, 22 September 2003.

[24] *ICTA 1988*, section 660G(1).

> The income tax legislation on settlements comprises Part XV of ICTA 1988 (sections 660A to 694). It is currently proving highly controversial because of the following extension: "…a settlor shall be regarded as having an interest in property if that property or any derived property is, or will or may become, payable to or applicable for the benefit of the settlor ***or his spouse*** in any circumstances whatsoever."[25]
>
> Based on this extension, the Inland Revenue is seeking to apply the settlements' provisions to a number of common situations in which husband and wife both hold shares in a family trading company and dividends are paid to the wife.[26] The correct application of the tax concept of settlement is highly difficult, at the best of times; there is continuing technical doubt as to whether certain Court Orders commonly made on divorce in respect of the matrimonial home are settlements for tax purposes or not.[27]
>
> In modern times it might be considered questionable why an individual's spouse – including a separated spouse - should be particularly singled out for prejudicial treatment under anti-avoidance legislation. The tax concept of "connected person" is already very broad and could if necessary be extended to include unmarried partners LTAHAW[28] as well as spouses and blood relations. Given the Inland Revenue's pursuit of married couples at the present time, if the definition of spouse here were extended to include partners in a civil partnership, many same sex couples in business together might be well advised to consider whether entering into a civil partnership might not be severely prejudicial to their joint tax position.[29]

An exchange of correspondence between the profession and the Revenue did not resolve the issue, as a press notice issued by the CIOT in November 2003 showed:

> In an unprecedented show of unity, the heads of the UK's leading tax, accountancy and business bodies have strongly criticised the Revenue's position on Section 660A, characterising it as a secret husband and wife tax. This obscure but important legislation is commonly known as the "husband and wife tax" because of its effect on small businesses. If left unchallenged the Revenue's controversial interpretation is likely to leave thousands of small business facing unexpected and hefty tax bills. Whilst the Revenue argues that only 30,000 companies are potentially at risk, the professional bodies believe the figure is much higher (bearing in mind the number of companies started in recent years) and that in any event even 30,000 is too high a number of businesses to be faced with uncertainty …

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25 ICTA 1988, section 660A(2); emphasis added.

26 Inland Revenue Tax Bulletin No 64, April 2003; analysed in, for example, *Taxation*, pp. 422-444 (17 July) and 477-479 (31 July).

27 Mesher and Martin or "deferred charge" orders, for example, excluding one spouse for a period from the matrimonial home which will later be sold for the benefit of that or both spouses; the uncertainty arises because the judge, not the excluded spouse, is making the disposition. For a useful introduction, see the discussion by Professor J E Adams, *Marriage Breakdown*, chapter 40 in *Tolley's Tax Planning*, 2002-03.

28 ["Living together as husband and wife" (LTAHAW): this is a technical concept, developed through social security case law and practice and encapsulated in the Department for Work and Pensions' very detailed "Guide for Decision Makers" at: http://www.dwp.gov.uk/publications/dwp/dmg/vol03/ch11b.asp].

29 Tax Law Review Committee, September 2003 pp 15-16

> "This is another stealth tax" said Mark Lee, Chairman of the ICAEW Tax Faculty. "The Revenue did not publish their interpretation of this legislation until 2001, and then only in a technical manual rarely read even by tax specialists. Nevertheless, they are applying their view for at least the last six years, which means many small businesses could face backdated and unexpected tax bills."
>
> This view was strongly endorsed by Tim Ambrose, President of the CIOT, who said "we believe that the Revenue have a legal and moral obligation to inform taxpayers of how the legislation is going to be applied. Their current approach is arguably a breach of human rights." The professional bodies have suggested a more pragmatic approach, which fits better with self-assessment. "We believe that taxpayers should normally self-assess on the basis that they are not within these rules, unless the opposite is clearly the case. The Revenue could challenge this self-assessment within the normal time limits, but the onus would be on them to prove their case" suggested Mr Ambrose. "We are particularly worried that small businesses, which are the engine room of the economy, are being distracted by this unfair tax at a time when they should be concentrating on the market recovery" said John Walker, Policy Chairman of the FSB.[30]

A series of PQs in January 2004 gave few details, other than confirming the Revenue's intention to publish more guidance:

Husband and Wife Tax

> **Brian Cotter:** To ask the Chancellor of the Exchequer what measures have been used by the Inland Revenue to notify small businesses of their obligations under section 660A of the Income and Corporation Taxes Act 1988; and if he will make a statement.
>
> **Dawn Primarolo:** The Inland Revenue's Trusts Settlements and Estates Manual is publicly available and contains some guidance on this. Further detailed guidance (with examples) of the interpretation and application of Section 660A Income and Corporation Taxes Act 1988 was published in Tax Bulletin 64 in April 2003 and was followed by further explanations and examples in November and December 2003. More guidance will be in the February edition of Tax Bulletin.
>
> **Brian Cotter:** To ask the Chancellor of the Exchequer how much revenue has been raised under section 660A of the Income and Corporation Taxes Act 1988 in each of the past six years.
>
> **Dawn Primarolo:** The information is not available.
>
> **Brian Cotter:** To ask the Chancellor of the Exchequer if he will make a statement on the impact that backdating payments under section 660A of the Income and Corporation Taxes Act 1988 will have on small businesses.

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[30] CIOT press notice, *Tax, Accountancy and Business Bodies Criticise "Secret Husband and Wife Tax"*, 17 November 2003

> **Dawn Primarolo:** Section 660A Income and Corporation Taxes Act 1988 applies to individuals. By paying tax under this section for earlier years individuals are simply paying the tax that would have been due if they had not sought to avoid tax.
>
> **Brian Cotter:** To ask the Chancellor of the Exchequer how many inquiries the Inland Revenue has received from small businesses in regard to section 660A of the Income and Corporation Taxes Act 1988.
>
> **Dawn Primarolo:** The information is not available.[31]

The Revenue published further guidance in *Tax Bulletin* in February 2004, focusing on the application of the settlements legislation to small companies and partnerships, and giving guidance on completing a SA return where the legislation applied.[32] The piece also discussed a number of general principles; a short extract is given below – looking at two questions mentioned above: the position of ordinary shares (rather than preference shares), and the question of whether family arrangements should be treated differently:

> **Shares**
> Much of the feedback we have received on the Tax Bulletin 64 article concerned ordinary shares and the rights that they carry. Whilst the rights and obligations associated with a share are relevant they are only part of the issue. We have not suggested that, for the legislation to apply, an ordinary share itself must be wholly or substantially a right to income. We look at the whole arrangement, as the legislation requires. The relevant questions are: What has been invested? What assets, trade, profession have been placed in the company and by whom? Who does what to earn the income of the company? Is the remuneration paid at a commercial rate for the job? Is someone getting a disproportionate return on the capital they have invested because of their relationship with the settlor? All these issues must be considered and if the shares are being used as a vehicle for diverting income then the legislation may apply.
>
> It has also been argued that as the shares in Young v Pearce [1996] STC 743, were preference shares, ordinary shares cannot also be caught by the settlements legislation. We do not accept that. The Young v Pearce case was determined on the facts in that case and the question whether the settlements legislation can apply to situations involving ordinary shares was not considered …
>
> **Family company/partnerships**
> We have been asked to reconsider the application of the settlements legislation to family/company arrangements as it has been suggested these involve special factors. We consider this is a misunderstanding of the settlements legislation which was enacted specifically to prevent individuals avoiding tax by diverting income to a family member or friend. An outright gift of money is a bounteous act but does not

[31] HC Deb 5 January 2004 cc 2-3W

[32] "Businesses, Individuals and the Settlements Legislation – part II", *Tax Bulletin*, issue 69 February 2004 pp 1085-1094

create a settlement. But an arrangement for one spouse to receive the other's income via dividends is caught by the settlements legislation. There is a substantial body of case law on "bounty" and the suggestion that the rules should be applied differently in a family situation is not consistent with that case law.[33]

In this article the Revenue noted that both this and its predecessor "[set] out the Inland Revenue's view of the way the legislation applies [although] that view is not accepted by many accountants and tax practitioners." In a piece in the *Independent* in December 2003, John Whiting and Anne Redston – both stern critics when the issue arose – were both quoted:

> The problem lies with interpretation of Section 660A of the Income and Corporation Taxes Act of 1988. The result is that all or most of the dividends from businesses jointly owned by husband and wife may be treated as the income of the higher earner - no matter how the company itself distributes the dividends between them - causing more earnings to trip into higher rate tax. The Revenue argues that dividend payments should broadly reflect the involvement of each partner in the business, and where they do not, the Revenue may treat the dividends as being paid to the higher earner. In many cases the Revenue is applying the interpretation back over the last six trading years - and charges interest on the unpaid tax …
>
> Many of [those couples affected] are now receiving bills of £20,000, £30,000 or £40,000, says John Whiting, tax partner with accountants PricewaterhouseCoopers and a former president of the Chartered Institute of Taxation. "It's handy cash for Gordon's coffers coming from small businesses," he adds. "It can be a couple of years' earnings … I believe at the minimum the Revenue is applying the rules differently. It has hit a lot of small businesses who did not know they were doing anything wrong and neither did their tax advisers." He adds that if the Revenue's approach is correct it provides an almost impossible challenge for couples in completing their self-assessment returns, because they will have no idea what proportion of the spouses' dividends the Revenue will accept can be applied to the lower earner.
>
> Anne Redston, tax partner with accountants Ernst & Young, says: "I think there are three problems. First, there are many people who think the Revenue is wrong technically. Second, even if they are right technically, they did not tell anyone and even if you were a specialist in this area you were unlikely to know because they said it in a journal published on the Web. And they only said in 2001 they were claiming back tax to 1994. My third problem is that it is very difficult for people to decide whether it applies to them. It's a nightmare for small businesses."[34]

In another article on this issue appearing in the *Telegraph* in October 2003, one practitioner predicted that there would be a substantial number of cases where the Revenue challenged this type of arrangement come the new year: "George Bull, tax partner in accountant Baker Tilly, explained: … "we will see lots of challenges coming through within a year of January,

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[33] *op.cit.* p 1086

[34] "Husband-and-wife tax hits small firms", *Independent*, 6 December 2003

2004, which is the deadline for unincorporated businesses to file their accounts for the year which ended in March this year."[35] In June 2004 a test case came before the Special Commissioners which generated considerable interest in the profession and freelance consultancy groups.[36] However the judgement in this case[37] – which was published in September – does not appear to have provided a definitive answer to these questions to the satisfaction of the profession, as the *Financial Times* has reported:

> More than 100,000 family businesses face continued uncertainty about their tax affairs, after the Inland Revenue declined to give detailed advice about a rule that could force them to pay an extra £1bn. In a meeting with leading accountants, the Revenue acknowledged the need to clarify its interpretation of the controversial rule, but said it could not discuss the repercussions of a landmark judgment last week for legal reasons.
>
> The controversy concerns the Revenue's use of legislation from the 1930s to clamp down on companies where one spouse brings in most of the income but both share dividend payments equally. A special commissioners' judgment last week about the case of Diana and Geoff Jones, owners of Arctic Systems, a Sussex information technology company, backed the Revenue in finding that the dividend payments did not accurately reflect the contributions to the company made by the husband and wife. A decision on whether to take the case to appeal is expected in the next few weeks. If the Joneses decide not to appeal, the Revenue is expected to issue detailed guidance explaining what sort of businesses are likely to be caught by the rule, known as 660A. Both the Revenue and the accountants, who have formed a pressure group known as the 660A Group, described yesterday's meeting as helpful. "We were encouraged by their willingness to listen," said Anne Redston, of Ernst & Young. The Revenue seemed anxious to defuse the row, said Mike Warburton, of Grant Thornton. "They are keen to lower the temperature."
>
> The ramifications of last week's ruling may turn out to affect a relatively small number of companies, according to BDO Stoy Hayward. "The ruling will primarily affect people who significantly restrict their own income to transfer income to their non-working spouse," said Stephen Herring, a tax partner. "I consider the scale of this issue has been blown out of proportion." But the continuing confusion, which will hamper businesses filling in their tax returns in advance of the January deadline for self- assessment, has added to complaints that small businesses find the tax regime confusing and burdensome. Chas Roy-Chowdhury, head of taxation at ACCA, the accounting body, said: "Because the law is so uncertain, we think many family business owners are providing the wrong information on their tax returns. Taxpayers need clear, concrete guidance." Many small businesses and their advisers are angry that the government is treating a long-established practice designed to minimise tax as

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[35] "Married until death or the Inland Revenue do us part", *Daily Telegraph*, 18 October 2003

[36] "Small business await result of tax test case", *Financial Times*, 14 June 2004 & "Section 660A appeal", *Taxation*, 24 June 2004. Further details are published on a freelance consultancy site, cited by *Taxation*, at: http://www.shout99.com/contractors/index.pl?section=65

[37] Jones v Garnett (Decision number spc/00432, 28 September 2004). The decision can be downloaded from: http://www.financeandtaxtribunals.gov.uk/index.htm

> tax avoidance. "Businesses are structured this way so they could take advantage of tax breaks they are entitled to," said Mr Roy-Chowdhury. "The government is turning the tables on what was regarded as good practice."[38]

The Government's position on this question was set out in a recent written answer:

> **Mr. Flight:** To ask the Chancellor of the Exchequer if he will make a statement on the application of the decision of the Special Commissioners of Income Tax in the Jones and Garnet case to (a) circumstances where one director only has the power to declare dividends and (b) other husband and wife-owned businesses. [191132]
>
> **Dawn Primarolo:** The Special Commissioners' decision in this case is still being considered. However the decision supports guidance published by the Inland Revenue in Tax Bulletins of April 2003 and February 2004 on the application of the legislation in Sections 660A-660G of the Income and Corporation Taxes Acts 1988. Whether the legislation applies in any particular case will depend on the detailed facts of that case and the arrangements between the parties involved.[39]

C. Budget 2004

In the 2004 Budget the Government announced that the rules dealing with jointly owned shares in close companies would be changed, so that distributions would be taxed "according to the actual proportions of ownership and entitlement to the income."[40] Details were given in a Budget Note, an extract from which is given below:

> **Current law and proposed revisions**
> At present, income from property (such as company shares or a rented house) that a married couple owns jointly is treated for tax purposes as belonging to them in equal shares, in accordance with section 282A Income and Corporation Taxes Act 1988, unless an election is made under section 282B for the income to be taxed according to the actual proportions of ownership and entitlement to the income.
>
> This change will mean that income distributions (normally dividends) from jointly owned shares in close companies (broadly small companies owned and run by five or fewer people) will be taxed on the husband and wife according to their actual ownership rather than in equal shares. For example, if the wife is entitled to 95% of the income from some jointly owned shares she will pay tax on 95% of the income from those shares. The guidance at IN115 and Form 17 will be updated to reflect this change …
>
> **Operative date** 6 April 2004.[41]

[38] "Tax rule spells anxiety for family businesses", *Financial Times*, 8 October 2004
[39] HC Deb 18 October 2004 c 552W
[40] *Budget 2004* HC 301 March 2004 p 200
[41] Inland Revenue Budget Note REV BN 22, 17 March 2004

In response to this announcement the *Times* reported that, "the move was prompted by fears among Revenue officials that some business owners were trying to avoid tax by diverting income to a family member in a lower tax bracket. [Francesca Lagerberg, tax partner at Smith & Williamson the accountant] said, 'This is yet another example of the Revenue cutting down every avenue they perceive to be unacceptable tax avoidance.'" In this context a recent written answer on the Government's approach to avoidance is notable:

> **Mr. McFall:** To ask the Chancellor of the Exchequer what is regarded by his Department as (a) legitimate and (b) illegitimate avoidance of tax.
>
> **Dawn Primarolo:** The Government take steps to close down tax avoidance schemes as they become aware of them, particularly where they create economic distortions, provide commercial advantages over compliant taxpayers, redistribute tax revenues in an unfair and arbitrary manner, or represent an abuse that conflicts with or defeats the will of Parliament.[42]

In the wake of this announcement, the *Financial Times* reported on the views of another practitioner on the use that has been made of the '50-50 rule': "Under current legislation, a spouse who owns most of the shares in a company can avoid tax by ensuring that most of the dividends are paid to a spouse who pays a lower tax rate … Simon Philip, a partner at Deloitte, the accountancy firm said: 'You would only ever do this to take advantage of a spouse's lower tax rate. This change increases the tax liability of the higher earning spouse.'"[43] Another practitioner writing in *Taxation* noted that no changes had been made in the settlements legislation:

> The section 660A argument (transfer of income to spouses) remains unaltered by the Budget, save that one statutory protection has been removed: the 'nominal joint ownership' scheme will be countered from 6 April 2004. This is the arrangement whereby shares beneficially owned largely or even wholly by one spouse are registered in the joint names of husband and wife in order to gain the deemed income-sharing afforded by section 282A. This provision will not apply to dividends to close companies.[44]

Provision to implement this measure was made in clause 86 of the *Finance Bill*, published on 8 April 2004 (it now forms section 91 of the *Finance Act 2004*). The explanatory notes to the Bill gave some background information on this clause – reproduced below:[45]

> As part of the introduction of Independent Taxation in 1990 section 282A ICTA88 was introduced to deal with assets owned by a husband and wife together. Unless an election is made to have income treated in accordance with actual ownership, it deems the income arising from certain property to arise 50:50 for tax purposes. The

42 HC Deb 1 April 2004 c 1695W

43 "Business vents fury over zero rate 'U-turn'", *Financial Times*, 18 March 2004

44 "Budget comment: business tax", *Taxation*, 18 March 2004

45 Explanatory notes to clause 86 (Income of spouses: jointly held property) of Finance Bill 2004 [Bill 89-EN]

purpose of the legislation was primarily to deal with the large numbers of assets, such as rental property, which spouses hold together to give a clear and simple basis of taxation without the need for enquiries.

This change to section 282A is now being made because it is being argued that it can be used to get around the effects of the anti-avoidance settlements legislation in sections 660A-660G ICTA88. Sections 660A-660G ICTA88 (the settlements legislation) exist to stop individuals gaining a tax advantage by transferring their own income to another individual who is taxed at a lower rate. A typical arrangement to which this legislation applies is where an individual uses a company to divert income to a spouse through the use of shares in the company.

For example, shares in companies, particularly those providing the skills, knowledge and expertise of one person, might be issued to that person and their spouse. These companies are "close companies" (as defined at section 414 ICTA88) which means, broadly, that they are controlled by five or fewer shareholders or any number of directors who are shareholders. Typically only one member of the couple earns the company's income although the other may be employed by the company. The main earner may then take an uncommercially low salary in order to leave profits in the company so a dividend can be paid. A proportion of the dividend then goes to the spouse who may not be liable to tax or liable only at the starting/lower rate.

The following examples show how the settlements legislation is used to prevent tax avoidance through the use of a company and how section 282A is now being used to get round that legislation:

Example of the application of settlements legislation
E Ltd provides the services of Mr E as an IT consultant to a number of clients working in the pharmaceutical industry. The company's share capital is £100 consisting of 100 £1 shares. Mr E is the sole director of the company. His wife, Mrs E takes no active part in the company. Mr and Mrs E each own fifty shares. The company has no significant capital assets.

The figures for the year's trading are: -

- Turnover £100,000
- Expenses £5,000
- Salary (Mr E) £10,000 (Market salary would be £80,000)
- Dividends £70,000

Because Mrs E owns 50 of the 100 shares, she receives a dividend of £35,000. However, this arrangement is caught by the settlements legislation and the £35,000 of dividends she receives are treated as Mr E's for tax purposes. It is only because Mr E chose to take an uncommercially low salary that sufficient funds were available to pay the dividends. Mr E has in effect diverted his income to his wife.

Using section 282A to avoid application of settlements legislation
Using the example above, E Ltd still has share capital of £100 consisting of 100 £1 shares, Mr E is still the sole director of the company, and his wife Mrs E still takes no active part in the company. However they subscribed for the 100 shares in joint names but make a legal declaration that Mr E is the owner of 99 per cent of the shares

> and Mrs E owns the remaining 1 per cent. Mr E now controls the company as he legally owns 99 per cent of it. When the dividend is paid out however, £35,000 is treated as Mr E's for tax purposes and £35,000 as Mrs E's. This happens because section 282A ICTA88 deems the income from the shares to arise 50:50.
>
> The settlements legislation does not apply to the vast majority of the dividends paid out. Mr E has not given anything away (apart from 1 per cent of the shares and income to which the settlements legislation could apply). Mr and Mrs E have therefore been able to use legislation designed to make things easier for husbands and wives to complete their tax returns to save significant amounts of tax. This amendment to section 282A will stop this avoidance by taxing Mr E on 99 per cent of the dividends and Mrs E on 1 per cent. So they will be taxable on the actual income to which they are entitled.

The clause was debated and approved unamended, following a vote, when it was scrutinised by the Committee of the Whole House on 28 April 2004.[46] Speaking for the Opposition Howard Flight criticised the proposal on two grounds: first that it "undermines the established principles of independent taxation relating to the assets of businesses jointly owned by husbands and wives", and second – that it would mean husbands and wives could not "protect themselves" from the Revenue's "controversial interpretation of section 660A … by moving to joint ownership."[47] An extract from his speech is given below:

> The section 660A attack on husband and wife owned businesses relies on being able to identify the way in which the shares are owned—namely, separately—as arrangements that create a settlement. The section 660 attack is the subject of litigation, which is set to be heard by the special commissioners this June … If left unchallenged, the Revenue's controversial interpretation of section 660A will leave thousands of small owner-manager businesses facing entirely unexpected and significant tax bills, from which, if clause 86 were enacted, they could not protect themselves in the future by moving to joint ownership …
>
> What are the issues here? By way of illustration, where a couple has set up a business, jointly managed, and one spouse runs it with the other doing a limited amount of unpaid work for the company; and where the net profit of the company after the husband's pay is then distributed equally to the two shareholders as dividends with each having the same shareholding; the Revenue is seeking to claim that the dividends paid to the unpaid spouse should be treated as the husband's income and subject to tax at his higher rate, backdated six years …
>
> A husband and wife can each own shareholdings. The wife's shareholdings may have been given to her by her husband, and I shall refer to a specific quotation in relation to such gifts. There is a blatant and unacceptable stealth tax where husband and wife assume the same risk on their equity investment. It is wrong for the Revenue to argue

[46] HC Deb 28 April 2004 cc 890-904

[47] *op.cit.* c 891. Mr Flight also raised the issue during the Bill's second reading (HC Deb 20 April 2004 c 198).

> that the non-salaried spouse's equity investment is wholly or mainly a right to income. The ownership of a share does not represent just a right to an income …
>
> Such is the Government's deviousness that neither the recent Budget notes nor the explanatory notes to this Bill provide any explanation of what clause 86 is really about. They give no clue as to the clause's relationship to the section 660A attack. Most small business owner-manager couples are as yet unaware of the Government's attempt to undermine their tax position as clearly set out when independent taxation was introduced, and to unravel the principles of independent taxation established in 1989. I am sure that the special commissioners will come to a just conclusion in relation to the section 660A attack in the case that will come up in June. However, we oppose clause 86, as it undermines the established principles of independent taxation relating to the assets of businesses jointly owned by husbands and wives.[48]

In response the Paymaster General, Dawn Primarolo, argued that the proposal did not constitute an "attack on the principle of independent taxation"; rather "the change simply stops couples manipulating the rules to save tax in a way not intended by Parliament when independent taxation was introduced."[49] She was also sceptical of the chances of a successful appeal against the operation of section 660A: "The hon. Member for Arundel and South Downs [Mr Flight] also said that there had been legal challenges with regard to small businesses about the Inland Revenue's application of settlements legislation, but I say to him that there have been no successful challenges. The tax system is challenged quite a lot."[50]

The Minister went on to give a useful explanation of how the proposal would work in practice:

> The settlements legislation exists to stop tax avoidance by means of the transfer of income from a higher-rate taxpayer to someone liable at lower rates or not at all. It is possible to side-step the legislation by transferring property into joint ownership, then declaring that most or all of the income belongs to one person only. The settlements legislation does not apply, because there has been no transfer of income, and section 282A of the Income and Corporation Taxes Act 1988 provides that income from property owned jointly by husbands and wives is taxed at 50:50—the settlement agreed in 1990 on the introduction of independent taxation. So, a person who is entitled to the whole of the distribution from a close company is taxed on only half of it, which was not the intention in 1990, and the clause provides that husbands and wives are taxed on the income to which they are entitled.
>
> I would stress that, in the avoidance that we are seeking to prevent, the husband and wife, having had the joint ownership, produce a legal declaration to apportion not on a 50:50 basis but on a 100:0 basis or 90:10 or whatever, so the taxpayers themselves are declaring that the situation is not 50:50 but something else. They are transferring to the partner—the spouse—who has taxable allowances to use up.

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[48] HC Deb 28 April 2004 cc 891-2
[49] *op.cit.* c 894
[50] *ibid.*

> Let us be clear about what the clause does. Its concern is close companies and only close companies—nothing else is affected here—that are jointly owned by a married couple, but where the company is really or mainly owned by one spouse and the married couple make a declaration to that effect. So, they tell us in that declaration that the ownership is not 50:50. Section 660A ensures that husbands and wives are taxed on their proper share in the income from the company.
>
> By making a legal declaration—I should stress that we are using their legal declaration, which is voluntarily provided to the tax authorities—that the ownership is not 50:50, and that the income actually belongs to the partner who is really entitled to it, husbands and wives are trying to neutralise section 660A. That allows section 282A to kick in, attributing income equally even though the taxpayers have told us in the declaration that, truly, it is not equally apportioned. We are trying to get the right result following the declaration that the taxpayer has provided to us about the true nature of the income and assets …
>
> Clause 86 gets us back to the right result. If the legal declaration is an accurate reflection of the ownership of the income—and it must be, because the husband and wife have signed it and declared it as a legal document—the husband and wife will be taxed on that basis. There is no need to look to the special rule that was provided in section 282A to work out their liability, because they have told us what their liability is and the tax consequences follow from that.[51]

Following the *Finance Act 2004* receiving Royal Assent, this particular measure does not appear to have been discussed in the House.

[51] HC Deb 28 April 2004 cc 895-6