



NIXONWILLIAMS

GUIDE TO INCOME SHIFTING



Income Shifting

The Settlements Legislation, more commonly known as the Income Shifting Legislation or Section 660 is one of the most important pieces of tax legislation relevant to contractors (along with IR35). The purpose of this guide is to explain its rationale, scope, implications and to provide an understanding of the current developments in this area.

Background

The Settlements Legislation is a piece of anti-avoidance legislation which has been around for many years, however it is only recently that HMRC have sought to apply the legislation to contractors operating through a limited company.

The purpose of the legislation is to prevent an individual from gaining a tax advantage by making arrangements to divert their income (or a portion of it) on to a third party who is liable to pay tax at a lower marginal rate.

The settlements legislation is written in statute under S.619 to 626 of ITTOIA 2005, a re-written and updated version of S.660A to 660G of ICTA 1988.

Example

A Ltd operates as an IT consultancy, below is an example showing a breakdown of the income attributable to the shareholders of A Ltd if there was a single shareholder and if the shareholding was split between two people - this example assumes that neither shareholder receives any other income than that derived from A Ltd and uses 2011/12 tax rates.

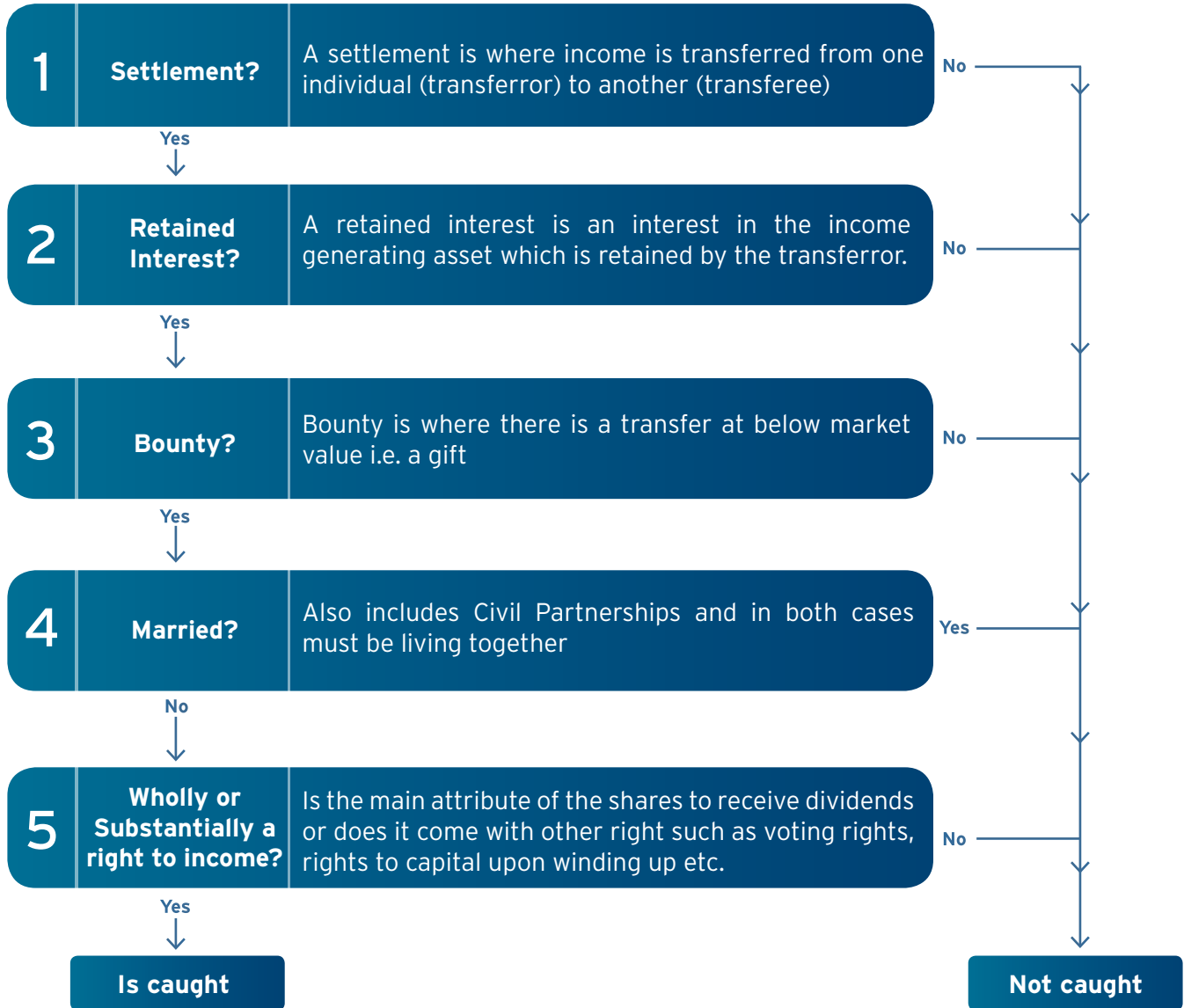
	Single Shareholder	Split Shareholding (50/50)
	£	£
Turnover	100,000	100,000
Salary	(7,000)	(7,000)
Pre-Tax Profit	93,000	93,000
Corporation Tax	(18,600)	(18,600)
Profit after Tax	<u>74,400</u>	<u>74,400</u>
Salary A	7,000	7,000
Dividend A	74,400	37,200
Tax A	(10,618)	(1,318)
Dividend B		37,200
Tax B		nil
Total Take Home	70,782	80,082
Advantage		9,300

Clearly, in the above example the take-home pay of the shareholders is maximised by splitting the shares in A Ltd as the tax payable on the dividends is reduced by utilising the second shareholder's basic rate band.



Scope

The below flowchart can be used to determine whether the transfer of an asset is classed as a settlement and whether it would be subject to the Settlements Legislation.



Implications

The implications of this are quite simple in theory, if there has been a transfer caught by the settlements legislation (with no exemption due to marriage etc.) then the transferor should be assessed on the value of if the income given away generated by the asset that they still have an interest in.

However, in practice it is not as straight forward as this.

Arctic Systems

Arctic Systems is the most famous test of Settlements Legislation in the UK courts, the case concluded in June 2007 with a House of Lords judgement in favour of the tax payer.

Arctic Systems Ltd was set up by Mr & Mrs Jones, each of whom subscribed to half of the shares. The turnover of the company was derived from the work undertaken by Mr Jones, however the salary paid to Mr Jones was much lower than this which resulted in high profits and dividends being paid out to Mr and Mrs Jones in accordance to their shareholdings.

HMRC argued that a settlement had been created on the basis that the shares owned by Mrs Jones was an arrangement to reduce the family tax burden rather than a transaction made at arms length. The basis of their argument was that Mr Jones would never have agreed to a complete stranger owning half of the business for £1 and so the arrangement was viewed as being bounteous.

The case went through the Special Commissioners (in favour of HMRC), the High Court (again, in favour of HMRC), the Court of Appeal (in favour of the tax payer) and finally to the House of Lords (in favour of the tax payer).

The judgement given by the House of Lords found that a settlement had taken place, but that Mr and Mrs Jones were not subject to the Settlements Legislation due to the spousal gift exemption i.e. there was an outright gift which was not wholly or substantially a right to income. The Jones' were entitled to the spousal gift exemption because they were both married and living together.

Given that this case went as high as it could go within the UK legal system a binding precedent has been set for all subordinate courts, they should therefore come to the same decision if faced with the same circumstances. However, if the situation is significantly different then the courts may come to a different decision.

Dividend Waivers

A dividend waiver is used by a shareholder when they do not want to receive their share of a dividend whether this is because they do not need the money, whether they want to leave funds in the company for other purposes or simply because they do not want to receive a dividend which they will pay tax on.

The use of dividend waivers effectively allows companies to distribute dividends to their shareholders disproportionately to the shareholdings in place with the co-operation of the shareholders however this is not what dividend waivers are intended to be used for as they must carry a commercial justification to be used correctly.

The precedent set by the Arctic Systems case would not necessarily apply to individuals that waive dividends paid to certain shareholders as dividend waivers were not used by Arctic Systems; this has been seen in the case of Buck v HMRC. In this case the company was owned by Mr and Mrs Buck whose respective holdings in the company were 9999 and 1, Mr Buck waived his entitlement to dividends in respect of his shares in order to increase the dividend paid to his wife.

HMRC put to the Special Commissioner that the waiver of the dividends constituted a settlement to which the outright gifts exemption could not apply. HMRC successfully argued that there was no commercial reason for the waivers to have taken place and they would not have taken place if the second shareholder was completely independent to the controlling director. As a result of this there was no gift of property (i.e. shares) only a gift of income and thus the settlements legislation applies.

Different classes of shares

As with dividend waivers, the use of separate classes of shares in a company effectively enables that company to distribute its profits to the shareholders disproportionately to that than if they all held the same class of ordinary shares.

To illustrate this with an example, consider the scenario where ABC Ltd has two shareholders and wants to pay dividends to each of the shareholders on an uneven basis. If each shareholder held 1 ordinary share (same class) they would both receive the same dividend, however, if each shareholder held different classes of shares (ordinary A shares and ordinary B shares for example) dividends could be paid unevenly by only declaring a dividend on one or the other of the classes of shares.

With this share structure the rights attached to the different classes of shares is very important. Where the different classes of shares have identical rights (which include voting rights and rights to capital upon winding up) the transfer or issuing of these shares may not create a settlement because it may be argued that the shares are not 'wholly or substantially' a right to income. However, this is a setup HMRC do not seem to approve of and the precedent created by the Arctic System case does not cover multiple classes of share, therefore, this is something we do not advise doing as it is much more risky compared to a split shareholding consisting of only ordinary shares.

If you have multiple classes of shares with different rights i.e. Ordinary A shares with voting rights and rights to capital upon winding up and Non-Voting B shares (no rights other than to dividends) then the B shares would be seen as wholly a right to income and therefore caught under the settlements legislation.

When could a share be 'wholly or substantially' a right to income?

The Arctic Systems case set a precedent that ordinary voting shares were not 'wholly or substantially' a right to income where they carried voting rights and rights to capital upon winding up as these rights greatly outweighed the right to a dividend (income), however, there are certain situations when the shares could be seen as a right to income and thus fail the criteria for the gift exemption to apply.

Multiple transfers of shares

If you are looking to change the shareholdings in the company between yourself and your spouse more than once then you may run into problems if you were to ever be investigated by HMRC as the spousal gift exemption may not apply. HMRC may try and argue the shares that are being transferred are indeed a right to income because there is the expectation to receive the dividends if the underlying reasoning behind the transfer to ensure one or both shareholder(s) are to remain basic rate tax payer(s).

Dividend payments shortly after transfers made

If you make a share transfer and then pay a dividend shortly after this you might find HMRC trying to argue that again, the transfer is 'wholly or substantially' a right to income. This due to the fact that there probably was an expectation that the dividend would be declared/paid when the transfer took place and as such it could be seen that the shares transferred are a right to income.



Transfers made when the company has high reserves

If you make a share transfer and the company has high reserves (or reasonable certain expectations of high profits) at the time the transfer takes place then the shares transferred could be seen to be 'wholly or substantially' a right to income due to the fact that there is an underlying expectation to receive large amounts of dividends from the company's reserves.

These factors should all be taken into account if you are thinking of making a gift of shares to your spouse or civic partner. You should also take into account HMRC's statement made shortly after the House of Lords decision taken from 'Arctic Systems Ltd (Jones v Garnett): HMRC guidance' on HMRC's website:

'We have been keeping open some similar cases to that in Jones v Garnett whilst we waited for the decision in the House of Lords. We will now review all these cases and will seek to settle them in line with the Jones v Garnett decision if appropriate. Not every case will be exactly the same as Jones v Garnett. We will consider each case on the basis of its individual facts, but unless there are any additional factors which might cause us to take a different view, we expect that most cases where the settled property comprises:

- ordinary shares in a company, or
- an ordinary (ie unlimited) interest in a partnership, will be within the exemption for outright gifts between spouses.'

<http://www.hmrc.gov.uk/practitioners/sba.htm>

Unmarried Couples

The precedent created by the Arctic systems case does not cover share transfers made between unmarried couples or indeed couples (whether married or not) who do not live together. The reason that the taxpayer won the case is because of the spousal exemption for gifts - this exemption does not extend to unmarried couples or couples not living together and so they would be caught by the settlements legislation.

Developments

Following HMRC's defeat at Arctic Systems, they published draft legislation to prevent married couples from gaining a tax advantage through income shifting - the rules under this legislation were due to take effect from 6th April 2008 and made any income shifted to another person assessable on the person who shifted the income. The proposals were highly controversial among tax professionals as the rules would have effectively ended one of the most effective and simple tax planning methods that could be utilised by owner managed businesses.

The Coalition government set up the Office for Tax Simplification in 2010, one of the areas that they have announced that they will be looking at is the taxation of small businesses, as part of this review the topic of income shifting may come up however some commentators have stated that it is not in the interests of the coalition government to introduce further rules on this - we will of course provide further updates as soon as any announcements are made by the government.

Conclusion

Income shifting remains one of the most effective and simple tax planning methods available to contractors providing it is done correctly - the couple should be married (or in a civil partnership) and living together, the shares transferred should be ordinary shares of the same class with the same voting rights. Ideally the transfer of shares should be made as close to incorporation as possible (or at incorporation), before the company has any value.

PREMIER SERVICE SUMMARY

what is included?



Set Up

- Form a Limited company at Companies House.
- Register your company for PAYE.
- Register your company for VAT.
- Register your company for Corporation Tax.
- Register your company for the VAT Flat Rate Scheme.
- Assist with opening a HSBC or Cater Allen Bank Account

Monthly

- Operate your payroll with payslips for each employee.
- Calculate and issue a profit statement for your company.

Quarterly

- Calculation & advice of VAT returns & payments.
- Calculation & advice of PAYE payments.

Annually

- Issue and file P14's/P60 & P35 with HMRC.
- Issue and file P11d & P11d(b) with HMRC.
- Calculate and advise of Class 1A NIC payments.
- Prepare & file annual accounts with HMRC.
- Prepare & file Corporation Tax return (CT600) with HMRC.
- Prepare accounts for Companies House.
- Prepare Companies House Annual Return (AR01).
- Personal Tax Return for one person if received by 30th September after the end of the tax year. A small charge may apply if you join part way through the tax year.

Ongoing

- Dedicated Account Controller including their direct phone number & email address.
- Unlimited telephone & email support.
- Ongoing book-keeping.
- Produce dividend vouchers and board minutes.
- Deal with any general HMRC correspondence and queries.
- Advise Companies House of company changes.
- Deal with change of address for the company and director.
- Mortgage and tenancy references.
- Complete National Statistical Office questionnaires.
- Deal with HMRC investigations where we have done the work, provided you have followed our advice and not concealed anything from us.
- If you decide to cease using our services, your only commitment is to give us one month's notice.
- If you choose to move to another accountant, we do not make a charge for the transfer.

Your obligations to us:

- Send us copies of your invoices.
- Send us your expense claim form.
- Send us a copy of your company bank statements.
- Respond to letters and emails from us.
- Pay our fees each month.

All Inclusive
Service for only
£95+ VAT
per month



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