

TAXREP 42/03

SECTION 660A, ICTA 1988: TAX, SMALL BUSINESSES AND THE SETTLEMENTS LEGISLATION

SECOND JOINT LETTER TO THE INLAND REVENUE CONCERNING THE SETTLEMENTS LEGISLATION AND SMALL BUSINESS

SUBMITTED BY CIOT, ICAEW TAX FACULTY, ICAS, ACCA, ATT, AAT, FSB
& WORKING TOGETHER REPRESENTATIVES

Tax Faculty Note

The history of this correspondence is as follows:

- Publication of an article in Tax Bulletin April 2003 (Issue No 64)
- First joint bodies letter in response to the Tax Bulletin article submitted in September 2003 (published as TAXREP 32/03)
- Response to first letter by Inland Revenue, published on the Inland Revenue's website on 4 November 2003 (<http://www.inlandrevenue.gov.uk/feedback/ciot-responses.pdf>)
- Second joint letter submitted on 10 November to the Inland Revenue – now published as TAXREP 42/03..

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SUBMITTED BY CIOT, ICAEW TAX FACULTY, ICAS, ACCA, ATT, AAT, FSB, CBI STEP & WORKING TOGETHER REPRESENTATIVES

- 1 We are pleased that the Inland Revenue have considered the points made in our paper, and in particular that they are considering the policy implications of Examples 3 to 5 in Tax Bulletin 64.
- 2 We still have serious concerns, however, with the Revenue position. Our specific comments on the Revenue's note to us are set out below, with the Revenue views in italics, and our comments following. We have summarised the key points on which we seek the Revenue's further clarification in a conclusion at the end of this document.

"Nevertheless many practitioners have known about, and had practical experience of, the Revenue's interpretation for many years"

- 3 We recognise that some individual practitioners have had past experience of Inspectors raising the arguments set out at Examples 3 –5. But this does not mean that the profession as a whole was aware that the position taken by the occasional Inspectors was official Revenue policy. We all do have occasional encounters with Inspectors who take their own views of the legislation, and we know that there are times when they take approaches that do not reflect Head Office policy. As we have frequently stated, there was no official guidance in an accessible form to make us (and still less the unrepresented taxpayer) aware that it was Revenue policy.

Based on representations made direct to us, and articles in the press (such as "The Revenue is Right". The Tax Journal. 22 September 2003. Page 11.), it is clear the views put forward in the paper are not universally accepted by the profession.

- 4 We are aware that Robert Maas shares the views of the Revenue on aspects of this issue and therefore that the profession is not unanimous. But the professional bodies who signed the paper were setting out the views of their members, and thus represent the vast majority of tax professionals. Feedback received from accountants and tax advisers at seminars on this issue since April 2003 has universally expressed surprise at Examples 3-5. It would however be unusual if no-one at all agreed with the Revenue position.

Ministers made clear during the debates on Independent Taxation during the passage of the 1989 and 1989 [sic] Finance Bill that the settlements legislation would be applied in future where there were effectively transfers only of income between husbands and wives.

- 5 We have now reviewed the Hansard debates on this issue. We agree that the Minister, Norman Lamont, said that the settlements legislation would be applied when there were transfers only of income between husbands and wives. He also said:

“Independent taxation is bound to mean that some couples will transfer assets between them with the result that their total tax bill be reduced. This is an inevitable and acceptable consequence of taxing husbands and wives separately....we have made it clear that we expect income splitting will occur.”

And:

“Provided that a gift of assets between husband and wife is free from conditions and is a complete and irrevocable transfer of the underlying capital as well as the income we see absolutely no case for imposing a tax penalty on the income from those assets.”

- 6 He distinguishes this from the limited scenarios where the exemption for gifts between spouses will not apply:

“Gifts that do not carry the right to the whole of the income from the property transferred, which are effectively transfers only of income, which are subject to conditions, or under which the donor may benefit directly, will not come within the scope of the provision... A married couple cannot obtain a tax advantage from a purely artificial transfer of income between them. But if the beneficial ownership of both capital and income is transferred, that genuine change of ownership will be recognised.”

- 7 We do not agree that the husband and wife businesses, where the wife owns, as a question of legal right, half of the company or partnership, is “effectively a transfer only of income”.
- 8 We are also of the view that Hansard indicates that tax avoidance and tax planning, in terms of asset allocation between couples, was an expected consequence of independent taxation and was accepted by the government of the time. These comments of the Minister do also help to explain why tax professionals did not expect that the Revenue were going to take this “tax avoidance” approach to small businesses – the whole tenor of the debate runs in the other direction.

We have no plans to significantly increase the number of formal enquires we undertake in this area at this time.

- 9 At our meeting with the Revenue in September we were pleased to receive confirmation that there was no intention to increase the number of enquiries. However this original straightforward commitment now appears to be suffering from limitation creep. This began with the insertion of “significant” in the final version of the draft notes of meeting, and now appears to be further restricted by the insertion of the words “formal” and “at this time”.
- 10 We should be grateful for confirmation that the Revenue have not changed the clear position set out at our meeting in September; namely that the Revenue do not intend to increase the number of settlement enquiries beyond the 100 or so per annum which they indicated already occur.

Based on the publicly available information, we have been able to identify less than 30,000 companies that could be like examples 3 and 4. (Companies with two shareholders, one or two directors and dividends being paid in the year.)

- 11 We are grateful for this information. Our greatest concern remains as to how each of the "less than 30,000 companies" work out whether they are one of the 100 that the Revenue actually feel falls within the ambit of the legislation. This difficulty is, in our view, incompatible with a self-assessment tax system.
- Clearly, in providing an estimate of the number of companies potentially affected, the Revenue have access to sources of information which are not available to practitioners, and this is very helpful. We would however appreciate some further clarification: Could the Revenue confirm whether the figure of 30,000 represented a single year?
 - If so, which year? In particular, we note the very high level of incorporations recently. We assume these are not yet included in "the publicly available information" as few will yet have submitted accounts or tax returns. Thus the numbers of those affected are likely to be greater than the Revenue figure and quite possibly more in line with the estimate provided by the professional bodies, that is, over 100,000.
 - In this context it would be helpful to know, from the information available, how many incorporations the Revenue are aware that there have been in the last three years.
 - We are also interested to know whether a similar exercise has been carried out for partnerships? It would be our expectation that the number of husband and wife partnerships where only one partner is "fee-earning" but both partners receive a profit share would be very high.

As it is clear that many practitioners were aware of our views prior to Tax Bulletin 64, and as enquiry cases have been settled on those lines, there can be no question of the interpretation as set out in examples 3, 4 & 5 applying only from April 2003.

- 12 We are unable to accept that "many practitioners" were previously aware of the Revenues current interpretation and we are disturbed by the continued assertion that publication of a single example within a Manual which was not made publicly available until 2001, and a single paragraph in an article written by a tax manager, should constitute sufficient public notice of the Revenue's views on behaviour which they regard as sufficiently reprehensible to warrant reopening of earlier years.
- 13 We have now considered this in the context of the Human Rights Act, and our comments are attached as Appendix 1 to this Note.
- 14 We are also currently reviewing the common law implications, namely whether the Revenue gave a "representation by silence" that taxpayers would not be attacked in this manner, and thus prior to the publication of TB64, they had a legitimate expectation that the Revenue would not apply the settlements legislation in these scenarios.
- 15 Those of our members who attended the many meetings with the Revenue on the introduction of self-assessment have no record or recollection of this Revenue interpretation being raised at those meetings. In the words of one prominent member

of the Self Assessment Consultative Committee (SACC), “as this interpretation makes self assessment next to impossible I am very surprised that they did not raise it.”

16 In addition, as mentioned at our meeting, we are concerned that the Revenue are opening enquiries under the self-assessment provisions, and then claiming that they can backdate the amounts claimed for six years. We assume that the Revenue are operating under the “discovery” provisions of TMA s29(5), namely that “the officer could not have been reasonably expected, on the basis of the information made available to him before that time, to be aware of the situation”, though this is commonly not explicitly stated in the correspondence.

17 However we would draw attention to the recent case of *Langham v Veltema* [2002] STC 1557. In that case Mr Justice Park said that:

“although the tax return and accompanying documents are obviously the starting point for the question of whether the Inspector could, “on the basis of” them, reasonably be expected to be aware that Mr. Veltema’s self-assessment was insufficient, the Commissioners and courts are not constrained to proceed on the unreal basis that the tax returns and accompanying documents must have been the only items of information which the Inspector had. If as a matter of common sense and normal administrative procedures it is likely that the Inspector would in fact have other items of information before him the statute does not require the question posed by s 29(5) to be answered on an unrealistic basis “

18 In our view, taking *Langham v Veltema* into account, “discovery” will not be appropriate in many of the settlement cases currently being worked by the Revenue.

However the department is not obliged to provide detailed guidance on every possible set of circumstances in which legislation could apply.

19 Given the Revenue’s own identification of something upto 30,000 possibly affected companies (presumably in a single year, and before the great surge in incorporations) plus an unknown number of partnerships which may be affected by this legislation, and which may find themselves with large and unexpected tax bills, we are surprised that the need for adequate guidance should be dismissed so lightly.

We have said we will look again at examples 3, 4 and 5 and, if appropriate, produce further guidance to help people self assess.

20 As previously discussed, it is clear that such guidance is needed. For example, in one letter the Revenue have written to the taxpayer as follows:

“The provisions in s660A apply to deem the dividends received by Mrs X to be her husband’s income for all Income Tax purposes. As he is liable to tax at the higher rates some additional liability will arise. I realise that Mrs X performed her duties for the company without remuneration. *I can therefore accept that part of the dividend she received represents a reasonable reward for her services.* Given the hours she worked *I have taken this part to be equal to 50% of the dividends paid in the accounting period.*”

- 21 Even if the Revenue are correct in their interpretation of s660A, how, under Self Assessment, is the taxpayer to know how much of the dividend is to be reapportioned back to the higher earner? 50%, as here; or should it be 60%, 40%, or the full 100%?
- 22 While we look forward to further guidance, we are nevertheless concerned that this will remain a subjective area and one which is not compatible with self assessment. We suggest that a better approach would be as follows:
- to accept as a matter of practice that the taxpayer can properly self assess on the basis that there is not an arrangement constituting a settlement unless it is clearly within the provisions;
 - if the Revenue wish to take a contrary view they may do so but only for the open year and not using it as a basis of the discovery.
 - the taxpayer is thus entitled to assume that an arrangement is not a settlement for self assessment purposes unless the Revenue argue otherwise, and that argument is accepted by the taxpayer or it is so held by the Commissioners.
 - This would give the taxpayer certainty in his self-assessment and be a workable, practical solution.
- 23 Such an approach would be similar to that adopted by the Revenue as regards the transactions in securities provisions; these only apply if the Revenue specifically invokes them. It also has parallels with the position (agreed after much discussion at SACC) of financial traders¹.

Interest cannot be waived but we have agreed that penalties will not normally be sought for 2002-03 and previous years in cases like examples 3, 4 & 5 involving the settlements legislation.

- 24 We welcome the fact that penalties will not be sought.

We do not agree taking an appeal to the Special Commissioners has to be an expensive exercise

- 25 We know that if a taxpayer takes the case himself, and is not represented, that this is not expensive. But it usually results in a David and Goliath battle which the taxpayer loses. A properly argued and prepared case at the Special Commissioners, including prior liaison with the Revenue, preparation of documents, briefing of witnesses etc, is unlikely to cost less than £7,500 (incl VAT which would not be recoverable).
- 26 This is a significant sum to most small business people, especially whilst facing an unexpected Revenue demand for back tax and interest. In addition, taxpayers are always advised that taking a case to the Commissioners is not necessarily the end of the matter – if they win there is a reasonable chance that the Revenue will appeal, and then the taxpayer has to fund the costs of the case going to the High Court and

¹ When self assessment was being introduced there was much discussion in SACC about the Crown option where the Revenue has power to determine, in the case of a financial trader, whether the investment income should be assessed under Schedule D Cases 3, 4 or 5 or under Cases 1 or 2.

The option is rarely used and the taxpayer may self assess on the basis he considers appropriate subject to the Revenue making a determination that on exercise of the Crown option a different basis has to be applied.

possibly further. This is a very daunting prospect for the owners of micro-businesses which are under attack.

We look at the whole arrangement, as the legislation requires.

- 27 We have a fundamental disagreement here, as to what is required by the legislation. In our view the income flows from the assets, and s660A(6) is sufficient to protect the taxpayer from a reallocation of the dividend income to the higher earner. In our view the Hansard debate supports our interpretation.

With respect to partnerships the Revenue again looks at the whole arrangement to see whether someone is getting a disproportionate return on their investment because they are related to, or friends with, the settlor.

- 28 The key question is not whether someone is getting a ‘disproportionate return’ but whether the partnership arrangements amount to “wholly or mainly a right to income” – which, because of the unlimited risk taken on, cannot in our view be the case.

In the Revenue's view the fact that the shares in Young v Pearce [1996] STC 743, were preference shares does not mean that ordinary shares cannot also be caught by the settlements legislation.

- 29 The concluding judgement of *Young v Pearce* is as follows:

Was the "property given"—the preference shares—"wholly or substantially a right to income"? It seems to me that the answer to that question must be in the affirmative. The preference shares entitled the holders to a preferential dividend if the taxpayers (the only directors and the holders of all the ordinary shares) determined to distribute the whole or part of the profits arising in any given year. Apart from that right to income, the only rights conferred on the preference shareholders were the right to repayment of the nominal sum paid on the allotment of the shares and the right to attend and be heard, but not to vote at, general meetings of the company. As a matter of strict legal principle, the preference shares were assets distinct from the income derived from them, but in reality they could never have been realised. The income was dependent upon the taxpayers determining to distribute part of the profits of the company.”

- 30 The factors set out here by Sir John Vinelott do, in terms, distinguish preference shares from ordinary shares, which have a bundle of rights including full rights to capital, votes and dividends.

We have not suggested that a "non fee-earning" spouse makes no contribution to a business. The question, in the context of the settlements legislation, is "What contribution does that spouse make and how commercial is the reward for it"?

- 31 We are pleased to note that the Revenue appear to accept that the role of the non-fee earning spouse has value. We invite them again to consider the fact that other courts (notably in divorce situations) have fully valued the contribution to building a business made by the non-fee-earning spouse.

- 32 We also reiterate the point made extensively in our earlier submission, that the Revenue's emphasis on the contribution made by the spouse ignores the legal reality. The non-fee earning spouse is either an ordinary shareholder or an unlimited partner in a business, and in consequence has rights and obligations. As we said in our earlier paper, the concepts of ordinary shareholder and partner "are at the hub of the professional bodies' concerns with the thrust of the Tax Bulletin article."

In a service company it is usually the person with the specialist knowledge who retains the interest because s/he controls the source of income.

- 33 We believe that this is a novel interpretation of the well-worn phrase "retaining an interest". Where an individual has 50% of the shares in a company, and can sue to obtain her share of the company's value, there are no rights in those shares retained by the spouse.

Looking at a typical service company scenario we have challenged, we do not accept the argument relating to "goodwill".

- 34 It is our experience, and this is reflected in the actual real-life examples set out in the Tax Bulletin, that the Revenue's attacks on small businesses are not limited to service companies.

Whereby a high earning individual agrees to work for a company for a very low rate of remuneration and allows a significant part of the earnings which they generate to be paid to someone else.

- 35 We found the superlatives in this comment helpful in the context of self-assessment, although we have not found this always to be the Revenue's approach in practice. Could they be more specific as to what they will regard as "very low" and "significant"?

At the other extreme, where, because of the nature of the business activity, the partnership has no significant capital base and a spouse who takes no part in the running of the business is made a 50% partner we believe that the settlements legislation can apply."

- 36 The partnership does not have to have a significant capital base and the partner can be "sleeping" but still be at risk if the partnership is sued - and can be made bankrupt. Most partnerships are not limited liability partnerships and it is an irrelevance whether the home has actually been mortgaged to provide working capital etc.

Parliament introduced the settlements legislation to prevent individuals transferring their income to a relative or friend in order to avoid tax

- 37 We concur with this statement, but would emphasise the fact that Parliament narrowly limited the legislation to deal only with transfers of income. As stated earlier in this paper, the Minister clearly stated that "if the beneficial ownership of both capital and income is transferred, that genuine change of ownership will be recognised". Thus a reduction in the family's income tax bill which occurs as a result of transfers of assets was specifically outside the scope of the legislation.

CONCLUSION

- 38 We would welcome the Revenue's further comments in the light of the comments in this paper which we will publish for the benefit of members of all constituent bodies.
- 39 As will be apparent from this second joint paper there are a number of areas where the professions consider that the Revenue's views on this subject are novel to say the least.
- 40 We have summarised below five key points extracted from the text above:
1. The incompatibility of the Revenue's views with the obligations on taxpayers to self-assess. We have suggested an alternative approach similar to that adopted by the Revenue as regards the transactions in securities provisions.
 2. The incompatibility of the Revenue's views with Hansard statements as to the impact of the settlements legislation on transfers between husband and wife.
 3. The distinction drawn in the decision of *Young v Pearce* between ordinary and preference shares confirming that ordinary shares are not "wholly or mainly a right to income".
 4. The significantly wider potential impact of the Revenue's view than is accepted in their 15 October paper.
 5. The impact of common law, the decision in *Langham v Veltema* and of the HRA on claims for back taxes and interest.

*The Chartered Institute Of Taxation
Institute Of Chartered Accountants In England & Wales
Institute Of Chartered Accountants Of Scotland
Association Of Chartered Certified Accountants
Association Of Taxation Technicians
Association Of Accounting Technicians
Federation Of Small Businesses
with the involvement of and contributions from the above bodies' Working Together
representatives.*

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Comments on Human Rights implications of Revenue approach to guidance on the settlements legislation

Article 1 of Protocol No. 1 to the Human Rights Convention provides that:

“Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law.

The preceding provisions shall not, however, in any way impair the right of a State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties.”

Taxation, as an interference with the rights guaranteed in Article 1 of Protocol No. 1, is justified thus under the second paragraph of Article 1. This provision expressly reserves the right of Contracting States to enforce such laws as they may deem necessary to secure the payment of taxes.

The recent case of *Spacek sro v. the Czech Republic* (ECHR November 1999) considers the publicity to be given to the law on the computation of a tax liability.

In that case, the requirements were published in a Bulletin put out by the Ministry of Finance. The Bulletin was available to subscribers and through retail outlets. The Court of Human Rights held that in these circumstances this degree of publicity sufficed.

However the decision might have been different if the Bulletin had not been generally available, and the court also pointed out that “the applicant company, as a legal entity, *contrary to an individual taxpayer*, could and should have consulted the competent specialists...” [our italics]

This seems to imply that, in the case of an individual taxpayer, it would not have sufficed for the government to say that the taxpayer could consult experts who would know of particular rules.

This case is relevant to the settlements debate because:

- It makes clear that while “the Convention does not contain any specific requirements as to the degree of publicity to be given to a particular legal provision”, nevertheless the Court’s decision is founded on the assumption that appropriate publicity was required if the Convention was to be fulfilled;
- In the case of the settlements legislation, it is clear that there was no published guidance from the Revenue on their view that it applied in the circumstances of Examples 3, 4 and 5 before the publication of the Trusts and Settlements Manual in 1991;
- In the light of *Spacek*, it is in our view unlikely that the ECHR would consider that publication in the Trusts and Settlements Manual was sufficient, in the case of an individual taxpayer, to give appropriate notice of the Revenue’s view as to how this legislation should be applied;

- Even if we are wrong in this, there was no publication before 2001 and thus this would appear to be the earliest date from which the Revenue can seek to enforce compliance with their view.

The authoritative “International Tax Law Reports” says of this case “what seems clear is that taxation based upon unpublished internal rules would be regarded as an unjustified interference with the enjoyment of possessions.”