THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

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SECTION 660A, ICTA 1988: TAX, SMALL BUSINESSES AND THE SETTLEMENTS LEGISLATION
COMMENTARY ON TAX BULLETIN ARTICLE

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

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Executive summary

There follows a detailed response to the Inland Revenue's April 2003 Tax Bulletin which gave its interpretation of how the settlements legislation affects small businesses and individual shareholders.

The settlements legislation has been in place for many years, but the Revenue's guidance has identified an issue of great importance to small businesses. Where, for example:

- a husband and wife are in business together, but one spouse is significantly more actively involved in the business than the other; and
- they own an equal number of shares, so that any dividend income arising from the business is divided equally between them

the Revenue said that the settlements legislation gives them the power to reallocate dividend income back to the spouse who does more of the work. Similar issues apply to husband and wife partnerships.

This response to the Bulletin article has been jointly prepared by six key organisations that represent tax professionals, namely:

- The Chartered Institute of Taxation (CIOT);
- The Tax Faculty of the Institute of Chartered Accountants in England and Wales (ICAEW);
- The Institute of Chartered Accountants in Scotland (ICAS);
- The Association of Chartered Certified Accountants (ACCA);
- The Association of Taxation Technicians (ATT); and
- The Association of Accounting Technicians (AAT).

with input from the Federation of Small Businesses (FSB) and representatives from the Working Together programme.

This virtually unprecedented combination of tax representatives issuing a joint response highlights the importance we all place on this matter and reflects the concern expressed by our members as regards the Revenue's interpretation of the settlements legislation.

Our main concerns are:

- Although some aspects of the Revenue's April guidance on the settlements legislation were previously known (for example, where restricted rights shares are used), key elements affecting everyday situations were not. Many taxpayers have taken actions, often with professional advice that reflected best practice, which they believed to be in accordance with the law, but which is now coming into question. The result could be income reallocated to the higher taxpaying spouse, thus leading to taxpayers facing unexpected tax bills running into many thousands of pounds.

- Taxpayers require clear guidance and as much certainty as is possible to ensure they fulfil their tax obligations, particularly in this age of self assessment. We believe that although the Revenue may have always held the views it expressed in the April guidance, for whatever reason this has not been communicated to taxpayers and their advisers.

- We do not accept a number of key technical issues that underpin the Revenue's April guidance. In particular we have concerns about the Revenue's view on the treatment of ordinary shares and its attitude towards partnerships. We believe the Revenue should look again at its view on these issues and reconsider whether its interpretation is correct.

- We have some reservations about a number of the examples provided by the Revenue in its guidance in particular with examples 3, 4 and 5. These relate to typical situations whereby a husband and wife both have shares in the family company or are partners in the family business.

Although publication of the Revenue's guidance is welcome, it has raised worries in the minds of many taxpayers who now need further help to either allay their fears or assist them to meet any tax obligations. The situation is exacerbated by the fact that the Revenue are applying their rules to situations which pre-date the April Bulletin. Our paper is therefore part of what we hope will be a process of developing that further guidance.

Our detailed comments are set out in the Paper we submitted to the Inland Revenue, which follows. The paper is being published by the participating bodies for the use of their members.

SECTION 660A: COMMENTARY ON TAX BULLETIN ARTICLE

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Background

The Inland Revenue published in Tax Bulletin 64 in April 2003 a lengthy article on "Business, Individuals and the Settlements legislation", revolving round their views on the application of Sections 660A to 660G. This article came about after a series of meetings with the CIOT on the subject of 660A at which CIOT argued that there was a need to get out into the public domain a proper exposition of the Inland Revenue view and practice in this area. CIOT had contended strongly that the Inland Revenue's stance was not widely known about and that, at a minimum, they had a duty to publicise their interpretation. CIOT were able to comment on drafts of the article but the final Tax Bulletin article remained very much the Inland Revenue's statement and CIOT disagreed with aspects of the article.

Subsequent to the publication of the article, there has been a great deal of commentary in the professional press on the subject. In addition there have been various meetings within professional and trade bodies and a degree of conferring between the professional bodies. It seemed sensible for that to lead to some comments on the Tax Bulletin article which might help isolate the areas of particular difficulty that the professions and by extension taxpayers have with the Revenue's position. One particular driver is the taxpayer's obligations under Self Assessment and the requirement for certainty and consistency.

The intention of this paper is to respond to some of the points made in the Tax Bulletin article. It does not of itself constitute the profession's whole response.

Is this a new view?

It needs to be recorded that the professional bodies are deeply concerned about what is seen as a new interpretation by the Revenue. The Revenue maintain that the Tax Bulletin is simply a new exposition of their long-held and consistent view; the appearance is, however that this is a new application of that long-held view. The result does appear to be retrospective taxation to those caught in what have previously been regarded as routine, everyday situations. It is abundantly clear from the responses that the professional bodies have received on the Tax Bulletin article that, to the vast majority of practitioners, the views expressed in the article on the applicability of s660A have come as a considerable surprise. Small family businesses have for decades been organised in a way that now seems to have caused offence to the Revenue.

It is not disputed that the legislation has its origins in the 1930s; it may well be that the Revenue have been consistent in their internal views of it but in the view of the professional bodies there has been no attempt until now to apply the rules widely in the way the Revenue now contend. It is accepted that recent amendments to the Revenue's settlements manual cover some of the more involved aspects but the routine situations now under threat are not dealt with. In any event, the Settlements manual is not exactly mainstream guidance and it is self-evident that the Revenue's views now being expressed have not been widely promulgated.

The Revenue have indicated elsewhere that articles in the professional press (in particular one in Taxation in 1996) showed that the Revenue were known to be looking at the application of the settlements legislation to small family company situations. All tax advisers are aware – or should be – that the settlements legislation can be used to attack certain family company situations (for example the sort of arrangements used in cases such as Young v Pearce – see below – or those involving minor children). But it is the alleged scope of the settlements rules now being expressed that was not known nor understood by the profession. In any event, our reading of the Taxation article is that it in fact follows the contentions set out in this response, and does not support the Revenue position.

To practitioners and taxpayers, this approach to s660A is at a minimum a change of practice; leaving aside the possibility of technical challenges to the newly expressed view (explored below), it should surely be the case that the view is only applied from the date that it becomes public – in other words April 2003.

In particular, it seems invidious that within an era of self assessment that taxpayers are expected to self assess in accordance with rules on which the Revenue promoted no guidance and have given no indication that they interpret them in this particular way. If the Revenue's views do prevail on the points which are in contention, interest and penalties should certainly only apply for tax years ending after 6 April 2003.

We also understand that all of the examples 1 – 9 are based on cases settled by the Revenue with taxpayers. Whilst that may be the case, it does not automatically mean the settlement was based on a correct interpretation of the law. The tax at stake, compared with the cost of litigation, too often forces taxpayers to accept a Revenue view which may well not be followed by a Court had litigation ensued. We find the Revenue attitude that if their interpretation is not accepted the taxpayer can take their case to appeal unacceptable when the cost of that route can be many times the tax at stake. (We suspect that disputes under the settlements rules would probably have to go to the Special Commissioners and may well then proceed at least to the High Court.) It is important to recognise that we are dealing here with family businesses, which have to prepare tax returns in a self assessment environment, and it is essential that Revenue interpretations are both workable and grounded on legal authority

We will now comment on the Tax Bulletin article itself, following the section headings within the article.

Definitions

The statements within Tax Bulletin under this heading are uncontroversial and reasonable summaries of the legislation. However, we would contend that either here or later in the article there should have been some discussion of two other crucial definitions: ordinary shares and partnership.

What is an **ordinary share**? Much of the Revenue's argument seems to rest on it being possible to treat an ordinary share as in effect an income right. That is simply not the case. With ordinary shares come full rights to capital, votes and dividends, together with the responsibility of being a shareholder. Decided Company law cases support this view. In essence, the terms on which a share is issued are the terms of a contract between the individual and the company in question. Thus, prima facie, an ordinary share is not "wholly or substantially a right to income". The Revenue have no authority under the tax statute to single out certain terms of the 'share agreement' and consider them in isolation from the other terms thereof. In other contexts, such a share valuations, the Revenue accept and indeed require voting and capital surplus rights to be taken into account for fiscal purpose as well as the right to dividends.

What of an **offer of partnership**? Undoubtedly if the business is profitable, that is a right to income, depending on the profit sharing arrangements. But is it "wholly or substantially a right to income"? Surely not – if the business runs into difficulty then the partnership is anything but a right to income. There is then the wider issue of the new partner taking on the obligations and burdens of being a partner as well as the rights and benefits, in particular liability for debts etc.

It may well be that these outline definitions are not acceptable to the Inland Revenue or are viewed as too simplistic or out of context but they are at the hub of the professional bodies' concerns with the thrust of the Tax Bulletin article.

There is then the question of what constitutes **a gift within the meaning of s660A(6)**. There is no basis in decided cases for the proposition that either (1) the gift of a shares from one spouse to another; or (2) the admission of a spouse into partnership is a gift of property that "is wholly or substantially a right to income" (vide TA 1988 s660A(6)).

Decided cases support the view that a gift of ordinary shares, with rights in a winding-up and voting rights are more than "wholly or substantially a right to income". The only decided tax case on the point is *Young v Pearce* [1996] STC 743, where Sir John Vinelott considered (at 755e-g) the attributes of particular preference shares that carried no rights in a winding-up, other that the return of the nominal capital and which gave no voting rights. Sir John Vinelott held that such shares were "substantially a right to income". *Per extenso*, if the shares had been ordinary shares with the rights given by Table A, they would have been more (or less?) than a right to income.

The Company Acts give holders of ordinary shares rights that go way beyond a right to income – vide, for example, Re a Company no 004475 of 1982 [1983] 2 All ER 36 for the rights of a member who is unfairly prejudiced. Matrimonial law is clear that a spouse who owns shares has a capital right.

For the admission of a spouse to partnership, one has to look no further than the analysis of the Privy Council in *Hadlee v Comr of Inland Revenue* [1993] STC 294. Barry Hadlee purported to transfer to his wife his right to income, while retaining for himself the proprietary interest in the partnership property. In the leading judgement of the Privy Council, Lord Jauncey held that right of a partner is "a beneficial interest in the entirety of the partnership assets and in each and every particular asset of the partnership" (at 297j).

Does the legislation only apply to transfers to spouses and minor children?

We agree with the two paragraphs under this section of the article – though as our comments below show we do not think the examples on this area are fully valid.

How does the legislation apply to non-trust situations?

It is helpful to have a list such as contained in the article setting out the sort of factors that the Revenue is concerned about. In many ways the professional bodies cannot take issue with this section: it is simply, after all, a list of the sort of issues that trouble the Revenue. However, as will be apparent from our comments on the nature of ordinary shares and partnerships, we have concerns as to the applicability of these brief outlines. In addition, we feel that a number of these factors will need to be present to run the risk of falling foul of the legislation, rather than a single item being the trigger.

We accept that s660A does not contain an "intent" statement. A settlement can in effect be created accidentally rather than it always being necessary to set out to create a settlement. However, as noted under the definitions section, the Courts have limited the scope of a settlement to where there is some element of bounty. The obvious trigger would thus be for the Revenue to prove that bounty was in the mind of the perceived settlor. But how is this to be applied in a family situation? It is in the nature of family arrangements that there is bounty in many acts. There needs to be an understanding by the Revenue that the arrangements necessary to set up a business often involve sharing of many burdens and issues within a husband/wife unit in a way that would not be paralleled between individuals who are unrelated. Where this is the case, it does not mean that the husband has set out to confer a settlement on the wife. The arrangement needs to be looked at as a whole and it needs to be borne in mind that in the widest sense families are partnerships and the duties and responsibilities accepted by one party may enable the other party to concentrate on the business in a manner which would otherwise not be possible. It is therefore not a question of bounty but a sharing of the risks and rewards of family and business life, which is the essence of most small businesses.

This Revenue approach has overtones of a very narrow view of husband and wife businesses. These may depend on one party, say the husband, to carry out most of the income generating work – for example, he may be an entertainer, plumber or IT specialist. However the wife rarely makes no contribution to the business – she is likely to provide a great deal of support and may organise the husband's engagements, deal with queries and take bookings. Divorce courts certainly recognise the wife's role in business success, including work carried out behind the scenes.

The settlements legislation does, of course, bear more heavily on married couples than unmarried couples because of the provision in s660A(2) that states that "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." It is thus much easier for the Revenue to apply s660A(1) because it is easier to show that an "interest" has been retained. By contrast, where an unmarried couple are working together in a business, the Revenue has to prove, as a question of fact, that one party has retained an interest in the property giving rise to the income received by the other. Thus an unmarried couple can share their income with far less difficulty. This might be described as a tax on marriage and is clearly discriminatory. It has, of course, always been intrinsic in s660A, but the wider use of the section by the Revenue increases the numbers of people affected by this discrimination.

We will now turn to the examples. In what follows, all comments on examples with shares must be read in the context of our understanding that ordinary shares are more than a right to income.

Example 1 – Issued shares with restricted rights

This example is based on the Pearce/Scrutton case and as such we have to accept it. We would merely emphasize that this was very much a case decided on the particular facts of the case and the restricted rights attaching to the (preference) shares – that they were in the circumstances very much a right to income.

Example 2 – Gifted shares with restricted rights

Again the nature of the shares seems important. The restricted nature of the rights attaching to the shares should put all involved on warning that the Settlements legislation could be invoked. As the example suggests, the whole arrangement needs to be looked at together – we endorse the comment within the example that "the property giving rise to the dividends cannot be looked at too narrowly as the shares alone". In other words, as we have contended earlier in this article, a number of factors need to be considered. If, for example, the shares did have voting rights and dividends were only paid out of profits after proper remuneration had been paid to the people involved in running the business, then we might well argue that the requirements of s660A are not satisfied.

We would also question the final sentence in the example ("Because he is in effective control of the company … he could simply pay all future income to himself …"). This seems a very sweeping statement – does it mean that everyone who controls a company is vulnerable to attack?

In any event, an investment return does not necessarily fail to be commercial simply because it is generous

Example 3 – Subscribed shares

In the 67 years since the settlements legislation was introduced, the Revenue have never stated publicly that they believe it applies to situations like this - where an individual subscribes for shares before the company starts to trade. There has been no public statement, no guidance, no press releases, no Tax Bulletin articles, until this April.

The technical basis for the view is questionable, as a settlement must create rights over some specific property or income. In this situation it is unclear what the "property" is – it should not be the shares themselves as they have been subscribed for at full value by the spouse.

It seems from standard letters received by taxpayers that the Revenue consider that "the combination of the granting of the right to subscribe, the shares themselves and the provision of funds to the company by the husband as a result of his work constitutes the 'property'" although this point is not explicitly made in the Bulletin. Assuming this to be the case, then:

1. If husband and wife each subscribe for shares at the same time and out of their own resources it is difficult to say that any "right to subscribe" exists at all: it is a mutual decision to invest;

2. If this combination is a settlement of property, is it not a gift from husband to wife and thus potentially covered by s660A? In this context we note that in the Young v Pearce case, Sir John Vinelott made no distinction between acquisition on incorporation and where there is a subsequent gift. He indicated that a direct issue of shares was to be regarded as an outright transfer and therefore potentially covered by s660A(6).

3. Assuming that s660A(6) is in point, so that there is only a settlement if the property is "wholly or mainly a right to income" then it is our understanding that no holder of the Ordinary Shares in E Limited has any right to income by virtue of being a shareholder. Certainly, once the Board of Directors have lawfully resolved to make an interim dividend payment a 'right' exists until the payment is made (though arguably the directors can rescind an earlier decision before the payment is made). Likewise a valid resolution passed at lawfully convened meeting of the shareholders declaring a final dividend (i.e. in accordance with the powers contained in the Memorandum and Articles of Association), also creates a right to income from the date of the resolution to the date of payment. However, prior to these events coming to pass at best Mrs E will have no more than an expectation of income which surely the courts would distinguish from being a 'right' falling within s660A(6)(b)

4. Any reasonable interpretation of subsection 6(b) is that the right envisaged by the draughtsman is an enduring right in existence at the time of the gift as opposed to merely an expectation that a right to a dividend would arise. For example, if Mr E was the sole director and he decided that the company should diversify into a new business and that neither he nor any other ordinary shareholder should receive a dividend, then Mrs E would not have any entitlement to a continued stream of dividend. Her expectations might well

have been dashed but a ‘right’ would not have been taken away because it would not have existed in the first place.

5. Looking at the work done by the spouse etc, this may be the source from which income is derived, but there is no right to income as such.

6. We wonder if perhaps the Revenue are focusing on what happens after the company has been set up – ie the steps leading to the dividend itself? However in our view the Revenue have no power to ignore some of the steps in an ‘arrangement’ so as to focus only on one or more steps which they select. It does not seem possible, given the wording of s660G, for the Revenue to focus solely on the one or two steps resulting in the dividend payment while ignoring the very first step in the arrangement, i.e. the acquisition by the spouse of the shares - the very assets giving rise to the income payment. Any such approach appears to have no basis in law. When all is said and done, it is clear that the first step in any arrangement which Mr E might make (in order to gratuitously pay dividends to Mrs E) is to lawfully transfer shares to her. There can be no dividend entitlement without shares. The arrangement must be looked at in the whole and there is case law to support this, see *Crossland v Hawkins* (1961, 2 AER 812).

In summary, we consider that this example, which is one of the most contentious of those within Tax Bulletin, is not well founded in law and the Revenue should reconsider their position.[1]

<u>Example 4 – Gifts of shares with little capital value</u>

The Revenue’s view here is surprising. As stated above, outright gifts between husband and wife are specifically excluded from the settlements legislation unless the property gifted is “wholly or substantially a right to income”. The Revenue argue that because the company has insignificant capital assets the shares are wholly or substantially a right to income and are thus caught by the rules. Many of the arguments against the Revenue position here are the same as those set out in Example 3 so they are not repeated again here.

No court case has ever supported the Revenue interpretation. Mr E gave Mrs E ordinary shares, and these carry a range of rights and not just a right to dividend income. For example, Mrs E is entitled to 50% of the company’s assets if it is wound up, and also has the right to vote in general meetings.

And what would happen if the couple split up? Surely Mrs E would demand her half share of the company – which means 50% of any income held within the company as well as 50% of any other assets such as the company’s goodwill. It is very doubtful whether a court would agree with the Revenue’s view that Mr E’s gift of ordinary shares was “wholly or substantially a right to income”.

In short, we see a fundamental factual difference between examples 3 and 4 and example 1 (based on Young v Pearce). In 3 and 4 the wife has full beneficial

[1] This case is discussed in more detail by Kevin Slevin in *Taxation* 31 July 2003.

ownership of half the company. In Young v Pearce the wives did not. We do not yet have a case that says the corporate veil can be pierced in the way the Revenue contend.

We are curious as to whether the Revenue feel there is a level of net asset value to the shares that would escape? If so, how can that fit into self assessment?

Example 5 – Partnerships

This example is also surprising. If one of the second hand cars proved to be dangerous and caused serious injury or death, the partnership could have to pay damages. Since partners have unlimited liability, all the partners' assets are at risk – the wives' as well as the husbands'.

Mrs F and Mrs G could thus lose their homes and all they possess as a result of becoming partners in the business. How then can the Revenue say that their share in the business is "wholly or substantially a right to income" when it brings with it these serious and life-changing risks? As partners, they are automatically identified as part of the business, are held out as such, etc.

And again, what would happen if the couples split up? Surely Mrs F and Mrs G would demand their share of the business – and the divorce courts would be likely to support them. This indicates that they do not have only a "right to income" and thus should not fall within the settlements legislation.

Example 6 – Dividend waivers

We can accept this example because it is clearly not possible for the dividend in question to be paid without the waiver. If it was an amount that could be paid without the waiver, but one shareholder did decide to waive for perfectly acceptable reasons, we would question whether the Settlements legislation would apply.

Both this example and Example 7 seem to assume a company can only pay dividends out of current profits.

Example 7 – Dividends on certain shares

We can accept much of the principle in this example. However, we are surprised by the suggestion that this is "clearly a bounteous arrangement". We are also unclear who is treated as making the settlement. Dividends are proposed by the directors, not by the shareholders. Also, is it correct to reach a view without taking account of the wider issues? What of past patterns of dividends? What if no dividends have been paid out until now on B shares whereas A shares have enjoyed significant dividends over the years? What if dividends are paid only on the A shares the following year?

Example 8 – Children – gift of shares from parent

We have no problem with this example of a Settlement in favour of unmarried minor children.

Example 9 – Children – gift of shares other than from parent

This example does cause us difficulties. Whilst we can understand the Revenue's concern if Mr J was wholly involved in these arrangements, why should not the grandmother subscribe for shares when a company starts up and subsequently gift them to grandchildren? What if grandmother's investment, albeit small, was important in helping the company to get started?

The situation is very different from unmarried minor children using money that they have in bank accounts in their own names to subscribe for shares. Then we could accept that there might be a Settlement by Mr J. But surely grandmother is independent and thus the legislation should not apply? Or are the Revenue open to being convinced in actual circumstances that grandmother was acting independently and the legislation should not apply? The example seems to imply that it matters not whether Mr J is adequately remunerated. Where he is, we question the existence of a Settlement even if one accepted the basic premise of the Revenue's views. In all this, where, then, is the essential certainty required under SA?

Where does the legislation not apply?

As an initial comment, we assume that there would be no question of a settlement being argued for if husband simply made over a bank account to wife, or agreed to make the bank account a joint one. In these cases the wife would have full access to the underlying funds and would be therefore in receipt of far more than simply a right to income.

Example 10 – An outright gift to a spouse

In this situation some shares are given away and the fact that they have a capital value and can be traded is put forward as the reason for the Settlements legislation not applying. Whilst we have no wish to argue with this, it seems to us that the same argument can be applied to basic situations similar to those in examples 3 and 4. There will always be an underlying capital value within a company and there will always be the possibility of trading them – there may not be a daily quote but any unquoted company can be bought and sold. How is it that this is so very different from the basic situations?

Example 11 – Subscribed shares

Similar comments apply – together with our general contention that shares are more than simply a right to income. It seems in this example that the Revenue accept our view.

Example 12 – Subscribed shares

Again we would not wish to argue with this decision. At the same time our concern is what is a "commercial salary"? Who is to say what it is in a particular situation – this illustrates the difficulty of applying this new Revenue interpretation in a self-assessment regime.

Example 13 – A partnership

We take it that the reason that the Revenue do not see this as a case for applying the Settlements legislation is Mrs O's original investment of £10,000. It is noted that she risked losing it if the business failed. It needs to be stressed that Mrs O risks losing a great deal more than £10,000 if the business fails – as noted at the start of this article, her entire wealth is at risk by the very nature of partnerships. It makes no difference in law whether the partner has subscribed £1 or £100,000. The tax result should not be different either.

Example 14 – A partnership

This seems to us to be a business issue and, correctly, the Settlements legislation is not in point.

Example 15 – Gift of shares other than from parent

Again the nature of the arrangements together with the time lapse means that Settlements is simply not in question in our view.

Summary

We have no concerns with the first paragraph of the summary. The second paragraph does seem to us to be a little biased. In particular the third and fourth sentences seem to ignore the reality that things apply within families that do not apply at arms length – it is simply unrealistic to assume automatically that the arms length test is wholly valid as family support is far more than simply encouragement.

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

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