

Businesses, Individuals and the Settlements Legislation – Part II

Introduction

In Tax Bulletin 64 we provided some information and examples on the settlements legislation in Part XV of Income and Corporation Taxes Acts (ICTA) 1988. Publication of that article was welcomed but many people have asked us for some further information on examples 3, 4 and 5. These were cases where the settlements legislation applied to small companies and partnerships. We have also been asked for guidance on completing a SA return where the settlements legislation applies.

As with the original article in Tax Bulletin 64, this article sets out the Inland Revenue's view of the way the legislation applies. That view is not accepted by many accountants and tax practitioners.

Unless otherwise stated all references are to ICTA 1988 in this article.

The existing guidance on the settlements legislation is found in the Inland Revenue's Trusts Estates and Settlements Manual which is available on our website at "www.ir.gov.uk/manuals/tsemmanual/". That manual will be updated to incorporate this further information shortly.

General

The feedback we have received on the Tax Bulletin 64 article was that the examples were particularly helpful so below we have provided some more examples. However there are some general principles that might also be of use.

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.

Partnerships

We have also received feedback on the application of the legislation to partnerships where some argue that the unlimited liability of the partners means the settlements legislation cannot apply. We do not accept that. It is important, in relation to partnerships, to look at the whole arrangement to see whether someone is getting a disproportionate return on their contribution because they are related to, or friends with, the settlor. If they are then the legislation applies even if a partnership is being used.

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 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.

Goodwill

It has been suggested that we have ignored the value of goodwill in a company in determining whether a gift of shares is substantially a right to income. We agree that goodwill can be a valuable asset of a business and each case will depend on its particular facts. In the typical service company scenario to which the settlements legislation may apply, goodwill is personal to the individual who earns the income for the company and does not attach to the company itself. In such circumstances goodwill would not be an asset for distribution in the winding up of the company and it will not enhance the value of the shares.

Spouses

There has been some misunderstanding about how the legislation applies when spouses are involved. 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?" The settlements legislation applies not only where there is a benefit to the settlor's spouse but also where the settlor retains an interest in the settlement *whoever the beneficiary may be*. 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.

The whole arrangement

It is essential to look at the whole arrangement when considering whether the settlements legislation applies. Sometimes the whole arrangement will not be clear until sometime after the company, for example, is set up. So we might need to wait until dividends or remuneration are paid before we can say the legislation applies.

What is a disproportionate return on capital?

We have said that one of the factors we look at when deciding whether or not the settlements legislation applies is whether someone is receiving a disproportionate return on capital invested. In deciding what is disproportionate we look at the return on the actual capital invested and also any risks. So, for example, someone who invests £1 in an ordinary share and gets £35,000 a year in dividends is getting a disproportionate return on the capital. If that £1 had been invested in the stock market or a bank the return would have been much less. On the other hand if an individual is admitted to a partnership they may take on considerable personal financial risk, and the partnership share of the profits might be a fair return for that risk (see example 14 below).

What is an uncommercial salary?

Likewise we have said we look at individuals drawing an uncommercial salary. In deciding what is uncommercial we look at the going rate for the job and also an individual's previous earnings. So if an IT consultant was earning £80,000 a year when employed by a plc and she then sets up her own IT consulting company and earns fees of £120,000 a year with expenses of £20,000 we would expect to see her drawing a salary of around £80,000. If instead her total salary is only £40,000 with £40,000 going to a non-working spouse then that is uncommercial.

Similarly if one spouse undertakes an average of 8 hours secretarial work a week for a company, and the going rate for a secretary in that area is £6 an hour (£2,496 per year), then we would consider it uncommercial if the spouse was in fact receiving £5,000 a year from the company.

Deciding on what is and is not a commercial salary is not an exact science. It is impossible to give definitive guidance as each case depends on the facts. When in doubt it is useful to consider whether

an individual employed at arms length would have accepted the same salary if their friend / relative was not also benefiting from the arrangement.

Completing the SA return

As section 660C(1) & (1A) sets out, income to which the settlements legislation applies is taxable either at Schedule F rates where it is dividends and dividend type income or under Schedule D Case VI for all other income.

When an individual completes a SA return and has to include income caught by the settlements legislation that income needs to go on the “Trusts etc.” pages (page T1) under “Income from Trusts and Settlements”, unless it is foreign income which should be returned on the foreign pages (Box 6.2 on FI for foreign dividends and box 6.4 on F2 for other foreign income). For UK source income the boxes to use on page T1 will depend on the type of income:

- For dividends and other Schedule F type income use boxes 7.10, 7.11 and 7.12.
- For all other income (taxed under Schedule D Case VI) use boxes 7.4, 7.5 and 7.6. Where the income is not taxed in the recipient’s hands then box 7.5 should be left blank.

We would also suggest individuals include suitable explanations in the “Additional Information” box. For example an individual receiving a dividend might not be required to include that dividend on the SA return as another person is taxable under the settlements legislation. If they both include a brief explanation about this it helps prevent unnecessary enquiries. (The figures in the returns will not necessarily agree with other information we might hold – for example from the company accounts.)

Previous examples in Tax Bulletin 64

In Tax Bulletin 64 we provided fifteen examples of where the settlements legislation did and did not apply. We have been asked to make clear for those examples how the income should be returned on the individuals’ SA returns. The fifteen examples are therefore reproduced below with an additional section explaining how SA returns should be completed.

Example 1 – Issued shares with restricted rights.

An engineering company has 100 ordinary £1 shares. Mr A and Mr B own 50 ordinary shares each. They create a new class of B shares which carry no voting rights and no assets in a winding up. They then issue 50 B shares to each of their wives. Dividends voted on those B shares would be treated as the income of Mr A and Mr B rather than their wives as the B dividends are from shares that are wholly or substantially a right to income and so not exempted from section 660A by section 660A(6). (This example is based on the High Court case of “Young v Pearce; Young V Scrutton [1996] STC 743”).

Completing the SA return

Any dividends paid to Mrs A on the B shares are treated as Mr A’s income under the settlements legislation and so he should return those dividends at boxes 7.10 to 7.12 on page T1 of his SA return and include a brief note in the “Additional Information” box.

Mrs A should not include any of the dividends received on the B shares on her SA return, if she gets one, but a brief note in the “Additional Information” box would be helpful.

The situation is the same for Mr and Mrs B.

Example 2 – Gifted shares with restricted rights.

Mr C is the sole director and owns all the 1000 ordinary £1 shares in C Limited. His aunt, Mrs D, has always been very kind to him and he wants to thank her for this. He subscribes, at par, for 100 B shares, with no voting rights and restricted rights to capital of £10 per share in the event of winding up.

He gifts the shares to Mrs D. Mr C then declares a dividend of £100 per share with Mrs D receiving dividends of £10,000.

This is a bounteous arrangement and we would apply the settlements legislation to the dividends. The property giving rise to the dividends cannot be looked at too narrowly as the shares alone. The wider arrangement must be considered. Because he is in effective control of the company Mr C retains an interest in the underlying property as he could simply pay all future income arising to himself as director's salary or as dividends on the ordinary shares.

Completing the SA return

All of Mrs D's dividends of £10,000 are treated as Mr C's income under the settlements legislation. He should return that £10,000 at boxes 7.10 to 7.12 on page T1 of his SA return and include a brief note in the "Additional Information" box. His own dividends should be returned in the normal way.

Mrs D should not include any of the £10,000 of dividends on her SA return, if she gets one, but a brief note in the "Additional Information" box would be helpful.

Example 3 – Subscribed shares.

E Ltd was incorporated in October 1997 to provide 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 £2 consisting of 2 £1 shares. Mr E is the sole director of the company, and his wife Mrs E is company secretary but takes no other active part in the company. From the beginning each subscribed for one share. The company has no significant capital assets. The figures for the first year's trading are: -

Turnover	100,000
Expenses	5,000
Salary (Mr E)	10,000
Salary (Mrs E)	5,000
Dividends	70,000

In this case Mrs E receives a salary for her duties as company secretary, but the whole arrangement whereby Mrs E invests £1 and in return gets a dividend of £35,000 is bounteous. There is nothing to suggest that the dividend is a commercial return on her investment. As there is no significant capital in the company, what has passed from Mr E to Mrs E is substantially a right to income and the whole of the dividend is taxed on Mr E.

In reaching this conclusion, the legislation allows us to look at the whole arrangement. It is the work that Mr E carries out which creates the company's profits which in turn enable the dividends to be paid. Mrs E's investment of £1 does not enable the company to make profits and the company itself has minimal capital value. In accepting a salary below the market rate from the company, and thereby allowing some of the income earned to pass to Mrs E as a dividend, Mr E has entered into a bounteous arrangement to divert income to his spouse with the aim of avoiding tax.

Completing the SA return

Mrs E has received a salary of £5,000 which is a commercial salary for the work she does. All of Mrs E's dividends of £35,000 are treated as Mr E's income under the settlements legislation. He should return that £35,000 at boxes 7.10 to 7.12 on page T1 of his SA return and include a brief note in the "Additional Information" box. His own dividends should be returned in the normal way.

Mrs E should not include any of the £35,000 of dividends on her SA return, if she gets one, but a brief note in the "Additional Information" box would be helpful. She should include the £5,000 salary on her return.

Example 4 – Subscribed shares with little capital value then gifted

As in example 3 but in October 1997 Mr E was not married and subscribed for both £1 shares himself. Mr E's solicitor was acting as company secretary. A year later he got married and gave his wife one of his shares in the company. At this point Mrs E took over the role of company secretary. In the following year Mrs E receives a wage of £5,000 and the company pays a dividend of £35,000 per share.

Since the capital value of the company is insignificant the gift of the share from Mr E to his wife is not exempt from section 660A by virtue of section 660A(6) as the shares are “wholly or substantially a right to income”. Accordingly the settlements legislation applies in relation to Mrs E's £35,000 dividend payment and the income would be treated as Mr E's for tax purposes.

Completing the SA return

As in example 3 all of Mrs E's dividends of £35,000 are treated as Mr E's income under the settlements legislation. He should return that £35,000 on page T1 his SA return at boxes 7.10 to 7.12 and include a brief note in the “Additional Information” box. His own dividends should be returned in the normal way.

Again Mrs E should not include any of the £35,000 of dividends on her SA return, if she gets one, but a brief note in the “Additional Information” box would be helpful. She should include the £5,000 salary on her return.

Example 5 – Partnerships

Mr F and Mr G are in partnership as second hand car dealers. They do not have any premises but buy and sell cars through auctions and the classified adverts of local papers. The partnership's only assets are some office equipment worth less than £1,000 and they usually have a couple of cars in stock at any one time. They are successful and the profits of £80,000 a year are split equally between them. They decide to admit their wives to the partnership and amend the partnership agreement in order to split profits equally four ways. Mrs F and Mrs G do no work in the partnership and the partnership has no employees.

This is a bounteous arrangement transferring income from one spouse to the other. The settlements legislation will apply and Mr F and Mr G continue to be taxable on half the profits each.

Completing the SA return

Mr F and Mr G are taxable on half the partnership profits each. So each should include £40,000 on their SA return. The £20,000 not caught by the settlements legislation is returned as partnership profits in the normal way. The £20,000 caught by the settlements legislation goes on page T1 in boxes 7.4 and 7.6. A note explaining this should be included in the “Additional Information” box.

Mrs F and Mrs G should not include the £20,000 from the partnership on their SA returns. However they should each include in the “Additional Information” box a note explaining that although they received £20,000 of profits from the partnership this is taxable on their husbands under the settlements legislation and has therefore been excluded from their individual return.

The partnership return should show overall partnership profits of £80,000. The partnership allocation should show £20,000 to Mr F, £20,000 to Mr G, £20,000 to Mrs F and £20,000 to Mrs G. The partners should add a note to the “Additional Information” box explaining that the £20,000 attributable to Mrs F and the £20,000 attributable to Mrs G are taxable on Mr F and Mr G respectively under the settlements legislation and are being returned on Mr F and Mr G's individual SA returns.

Example 6 – Dividend Waivers

Where a company with few shareholders declares a final dividend when one or more of the shareholders has waived their right to a dividend in circumstances where other shareholders may benefit, it is possible the settlements legislation could apply.

For example Mrs H owns 80 ordinary shares in H Limited. Mr H owns 20 shares. In 2000 the company made a profit of £25,000. Mrs H waived her right to any dividend. The company then declared a dividend of £1,000 per share, and Mr H, who had no other income, received a dividend of £20,000.

We would apply the settlements legislation in these circumstances. Clearly a dividend of this amount could not have been paid from the company's profits on all the shares, so the waiver arrangement enhanced the dividend paid to Mr H. £16,000 of the dividend paid to Mr H is attributed to Mrs H under section 660A because the waiver was a bounteous arrangement.

Completing the SA return

£16,000 of Mr H's dividends of £20,000 are treated as Mrs H's income under the settlements legislation. Mrs H should return that £16,000 at boxes 7.10 to 7.12 on page T1 of her SA return and include a brief note in the "Additional Information" box.

Mr H should include only £4,000 of the £20,000 dividends on his SA return in the normal way and add a note to the "Additional Information" box explaining why only £4,000 is being returned even though £20,000 was received.

Example 7 – Dividends on certain shares

As in example 6, but in this case Mrs I owns A shares and Mr I owns B shares. Both A and B shares rank equally. Again profits of £25,000 are made and a dividend of £20,000 is voted on the B shares while no dividend is voted on the A shares.

Clearly by not voting dividends on the A shares (which rank equally with the B shares) this is a bounteous arrangement as the dividend paid on the B shares could only be paid if no dividend was declared in respect of the A shares. £16,000 of the dividend paid to Mr I is attributed to Mrs I under section 660A because the decision to vote dividends only on certain shares was a bounteous arrangement.

Completing the SA return

£16,000 of Mr I's dividends of £20,000 are treated as Mrs I's income under the settlements legislation. Mrs I should return that £16,000 at boxes 7.10 to 7.12 on page T1 of her SA return and include a brief note in the "Additional Information" box.

Mr I should include only £4,000 of the £20,000 dividends on his SA return in the normal way and add a note to the "Additional Information" box explaining why only £4,000 is being returned even though £20,000 was received.

Example 8 – Children – gift of shares from parent

Mr J owns all 100 issued £1 shares in J Limited. Mr J is the sole company director and is the person responsible for making all the company's profits because of his knowledge, expertise and hard work. Mr J gives each of his four children 10 shares. Dividends are paid.

Section 660B applies and attributes the dividends paid to the children to Mr J for tax purposes. This is because Mr J has paid the income to his unmarried minor children.

Completing the SA return

Any dividends paid to his four children are treated as Mr J's income under the settlements legislation. He should return those dividends at boxes 7.10 to 7.12 on page T1 of his SA return and include a brief note in the "Additional Information" box. His own dividends should be returned in the normal way.

The four children do not need to return the dividends or inform the Inland Revenue they have received them. If they do receive a SA return, a note should be included in the "Additional Information" box explaining that although they received dividends during the year these have not been returned as they are taxable as Mr J's income under the settlements legislation.

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

As in example 8, but the 40 shares held by the children were originally owned by their grandmother who had subscribed for them at par when the company was set up but shortly afterwards had gifted them to her grandchildren.

Section 660B applies and attributes the dividends received by the children to Mr J for tax purposes. Since Mr J is the person responsible for making the company's profits and decides on the level of dividends paid, it is Mr J who is the settlor rather than the children's grandmother.

The legislation could apply in a similar way if the children had subscribed for the shares themselves with money received from a third party or even from bank accounts in their own names.

Completing the SA return

Any dividends paid to his four children are treated as Mr J's income under the settlements legislation. He should return those dividends at boxes 7.10 to 7.12 on page T1 of his SA return and include a brief note in the "Additional Information" box. His own dividends should be returned in the normal way.

The four children do not need to return the dividends or inform the Inland Revenue they have received them. If they do receive a SA return then a note should be included in the "Additional Information" box explaining that although they received dividends during the year these have not been returned as they are taxable as Mr J's income under the settlements legislation.

Example 10 – An outright gift to a spouse

Mrs L owns 10,000 ordinary shares in a FTSE 100 company. Those shares are worth £40,000. Mrs L gives those shares to her husband. Mr L is now entitled to all the dividends from the shares and can sell the shares if he wants and keep the proceeds. This is an outright gift of shares that are not wholly, or substantially, a right to income since they have a capital value and can be traded, so the settlements legislation does not apply.

Completing the SA return

As the settlements legislation does not apply all income should go in the normal boxes on the SA return.

Example 11 – Subscribed shares

Mr M is the sole director and owns all the 100 ordinary shares in M Limited, a small manufacturing company. The company employs 10 people and owns a small factory, a high street shop, tools fixtures and fittings and 3 delivery vehicles. Mr M draws a salary of £30,000 each year and receives dividends of £20,000. Mr M then gifts 50 shares to his wife who plays no part in the business. Mr and Mrs M then each receive dividends of £10,000.

We would not seek to apply the settlements legislation to the dividends received by Mrs M. This is because the outright gift of the shares cannot be regarded as wholly or substantially a right to income.

The shares have capital rights and the company has substantial assets so on the winding up or sale of the business the shares would have more than an insubstantial value.

Completing the SA return

As the settlements legislation does not apply all income should go in the normal boxes on the SA return.

Example 12 – Subscribed shares

Mr N wants to set up in business as a bookseller. He needs at least £100,000 to buy premises, equipment and stock. He sets up a company and he and Mrs N each subscribe for 40,000 ordinary £1 shares at par and the company borrows £20,000 from the bank. Mr N draws a salary which after four years is £40,000. Mrs N does not work for the company. Company profits are used to repay debt and expand the business. The business does well and after 6 years the profits are sufficient to pay a dividend of £10,000.

We would not seek to apply to apply the settlements legislation to the dividend of £5,000 received by Mrs N. There is no bounty as Mr N draws a commercial salary for his efforts and the dividend is a commercial return on the initial investment which was vital at the commencement of the business and contained a clear element of risk.

Completing the SA return

As the settlements legislation does not apply all income should go in the normal boxes on the SA return.

Example 13 – A partnership

Mr and Mrs O and their friend Mr P have a business idea. They want to open a Cycle Repair Shop. Mrs O does not want to work but agrees to invest in the business without taking an active part, that is to say she is a sleeping partner. Each partner invests £10,000 and the £30,000 is used to lease a shop, buy equipment and stock and keep the business going until trade builds up. Under the partnership agreement Mr O and Mr P receive £500 a week with all the remaining profits split three ways between the partners.

The business is a huge success and makes large profits and continues to grow. Within five years Mrs O is receiving £50,000 a year as her share of the partnership profits. Although Mrs O does not work in the business, and her initial investment has turned out to be very successful, the settlements legislation would not apply to treat her share of the partnership profits as Mr O's. Mrs O's original investment was vital to get the business started and she risked losing it if the business failed.

Completing the SA return

As the settlements legislation does not apply all income should go in the normal boxes on the SA return.

Example 14 – A partnership

Mr P is a self-employed engineer engaged on specialist work for a number of clients in the construction industry. Mr P employs his wife, who plays an active part in the business including ordering and collecting specialist parts. Mrs P is paid a salary of £20,000. The profits of the business are £40,000. Mrs P owns a substantial property inherited from her mother.

Because of a number of claims made against Mr P, his insurers want to raise premiums by £20,000. He doesn't think he can afford this so his insurers agree to not increase the premiums if Mr P agrees to pay the first £25,000 of any claim. Mr P and Mrs P enter into an equal partnership. Accordingly

Mrs P no longer draws a salary but is entitled to a share of the profits as well as being exposed to the liabilities of the partnership. The property she owns is therefore potentially at risk.

Mrs P's share of the profits is £30,000. Mrs P therefore has extra overall income of £10,000 because she has taken on the risk of the partnership liabilities including that associated with the £25,000 excess on the insurance policy. There is therefore no bounty and the settlements legislation would not apply.

Completing the SA return

As the settlements legislation does not apply all income should go in the normal boxes on the SA return.

Example 15 - Gift of shares other than from parent

In 1960 Mr & Mrs Q and Mr & Mrs R set up a small family cleaning company. In total there were, and still are, 100 £1 ordinary shares in the business. Initially Mr Q and Mr R each subscribed at par for 40 shares and Mrs Q and Mrs R each subscribed at par for 10 shares.

When Mr & Mrs Q died they each left their shares in the company (50 in total) to their daughter, Miss Q. When Mr R also died he left his 40 shares in the company to his daughter Mrs S. Miss Q and Mrs S are both directors of the company and carry out its day to day running. The current turnover of the company is approximately £1,000,000 per year and its capital value is over £250,000. Miss Q and Mrs S each receive a salary of £60,000 per year. Each year a dividend of £500 per share is paid.

Mrs R has retained her original 10 shares in the company since 1960. Without discussing the matter in advance with either Miss Q or Mrs S, Mrs R decides to give her shares to her five year old granddaughter who is also Mrs S's daughter. Mrs R makes the gift on her granddaughter's next birthday.

The settlements legislation would not apply to this case since Mrs R retains no interest in the shares which she gives to her granddaughter and is therefore not a settlor within the meaning of section 660G. Nor is Mrs R's decision to gift the shares to her granddaughter part of a wider arrangement with Mrs S to settle income on the child.

Completing the SA return

As the settlements legislation does not apply all income should go in the normal boxes on the SA return.

Additional examples involving a company

Examples 3, 4 & 5 plus examples 11, 12 & 13 explained circumstances in which the settlements legislation did and did not apply to some company and partnership situations. We have been asked to provide further examples like these, which are below. These examples also have guidance on completing the SA return:

Example 16 - Subscribed shares

T Ltd was incorporated in October 1997 to provide a consultancy service to the health sector. Mr T is an IT specialist with a number of years experience in the health sector and Mrs T is an ex-nurse who specialises in producing computer based learning materials for hospitals. The company's share capital is £10,000 consisting of £10,000 £1 shares. Mr and Mrs T are both full time working directors of the company. From the beginning each subscribed for £5,000 shares. The first year's accounts show that each director received remuneration of £30,000 and that profits available for distribution were £50,000. £30,000 profits are retained in the company to build up the business. A dividend of £2 per share is declared and paid – each shareholder receiving £10,000.

There is no bounty here and no arrangement to which the settlement legislation can apply.

Completing the SA return

As the settlements legislation does not apply all remuneration and dividends should go in the normal boxes on the SA return.

Example 17 - Subscribed shares

Mr U is a self-employed IT consultant. He reads an advert on a specialist website and as a result he decides to offer his services through a “composite” company set up by another company specialising in taxation services. Under an agreement he will subscribe for a special class of share (a £1 “U” share) which has rights to all his earnings less a “commission” paid to the organisers. When the agreement is sent to him for signature there is a box to tick if he wants a share issued to anyone else. He ticks the box and asks for an additional share to be issued to Mrs U. Apart from subscribing £1 for the share, Mrs U takes no part in the business. During year one his efforts contribute income of £68,000 to the company. The company retains sufficient to cover expenses and tax and the balance remaining of £54,000 is paid to Mr and Mrs U as dividends who each receive £27,000.

This is a bounteous transaction caught by the settlements legislation. In reaching this conclusion it is necessary to look at the whole arrangement. The substance of what has happened is that part of Mr U’s earnings have been paid to Mrs U.

Completing the SA return

Mr U should return his own dividend income of £30,000 (£27,000 + tax credit of £3,000) on his SA return in the normal way. He should include his wife’s £30,000 on page T1 of his return at boxes 7.10, 7.11 and 7.12 return and include a brief note in the “Additional Information” box.

Mrs U should not include any of the £30,000 of dividends on her SA return, if she gets one, but a brief note in the “Additional Information” box would be helpful.

Example 18 - Gifted Shares

Mrs V carries on a trade as a designer through a company V Ltd. She is the sole director and sole shareholder of 100 £1 shares subscribed for at par on the company’s formation. The company’s accountant acts as company secretary. The company has insignificant capital. In a typical year the company’s gross income is in the region of £60,000 p.a. After expenses (including Director’s remuneration of £25,000) and providing for tax, the profits available for distribution are £24,000. Dividends of £20,000 are paid to Mrs V. In the following year Mr V, who worked for another company, is made redundant and loses his source of income. Mrs V gifts half her shares to Mr V. Mr V carries out some part-time secretarial work for the company for which he is paid £5,000 p.a. At the end of the year gross income is £65,000, Mrs V votes herself £10,000 remuneration and after other expenses and tax the balance of £40,000 is paid out as dividends – each spouse receiving £20,000.

This is a bounteous arrangement, whereby Mrs V has transferred part of her income to her spouse, and it is caught by the settlements legislation. In reaching this conclusion it is necessary to look at the whole arrangement. What has happened is that part of Mrs V’s earnings have been paid to Mr V. Two of the key elements in the arrangement are that the expertise and earning capacity of Mrs V have been provided to the company at undervalue and Mr V is paid a market rate for his work.

Completing the SA return

Mrs V should include her husband’s dividend income of £20,000 on page T1 of her SA Return at boxes 7.10, 7.11 and 7.12 and include a brief note in the “Additional Information” box. Her own dividend income of £20,000 goes on the main return in the normal way and her £10,000 of remuneration goes on the Employment pages.

Mr V should include the £5,000 of remuneration in his SA return, if he gets one, in the normal way but should not include the £20,000 of dividends. A brief note in the “Additional Information” box explaining why the £20,000 of dividends received are not on the return would be helpful.

Example 19 - Gifted Shares

The facts are as above but Mrs V continued to pay herself a commercial rate of remuneration of £25,000 leaving only £20,000 to be distributed to the two shareholders. The gift of shares is a bounteous transaction which diverts £10,000 of income to Mr V and in the absence of any capital in the company those shares represent substantially a right to income. So the exemption in section 660A(6) for gifts between spouses does not apply and the dividends are assessable on Mrs V.

Completing the SA return

Mrs V should include her husband’s dividend income of £10,000 on page T1 of her SA Return at boxes 7.10, 7.11 and 7.12 and include a brief note in the “Additional Information” box. Her own dividend income of £10,000 goes on the main return in the normal way and the £25,000 of remuneration goes on the Employment pages.

Mr V should include the £5,000 of remuneration in his SA return, if he gets one, in the normal way but should not include the £10,000 of dividends. A brief note in the “Additional Information” box explaining why the £10,000 of dividends received are not on the return would be helpful.

Example 20 - Gifted Shares

Mr W & Mr X are founder shareholders and directors of a successful hardware shop run through a company called DIY Ltd. The company was set up to acquire the partnership trade carried on by the two shareholders. At the time there was a single shop, the trade plus assets were worth about £50,000 which were transferred to the company and the company issued 10,000 £1 shares to the partners in return. Over the years the company has grown. It now owns a chain of 8 DIY stores. Some premises are owned and others rented. The company owns a number of delivery vans and employs 50 staff. The shares have increased in value from £5 per share to £75 per share. Mr W and Mr X respectively gift some of their shares to their wives. Mrs W & Mrs X are given 2000 shares each. Dividends are paid on all shares.

Although this is a bounteous transaction it is an outright gift that is not substantially a right to income, because the company has significant capital assets, and is therefore excluded from the definition of settlement by section 660A(6).

Completing the SA return

As the settlements legislation does not apply all income should go in the normal boxes on the SA return.

Further examples involving a partnership

Example 21

Mr Y, an architect, commences business as a sole trader. The business is successful and a few years later annual profits are in the region of £80,000. The business has insignificant capital and there are no employees. The business is transferred to a new partnership of Mr & Mrs Y. A deed is created under which profits are to be shared equally. Mrs Y subscribes no new capital and carries out no work whatsoever for the partnership. Profits for the year are £80,000 and £40,000 belong to Mrs Y. This is a bounteous arrangement transferring income from one spouse to another. The settlements legislation will apply and Mrs Y’s share of the profits will continue to be assessed on Mr Y.

Completing the SA return

Mr Y should include Mrs Y's partnership income of £40,000 on page T1 of his SA Return at boxes 7.4 and 7.6. His own share of £40,000 is returned as partnership profits in the normal way. A note explaining this should be included in the "Additional Information" box.

Mrs Y should not include the £40,000 from the partnership on her SA return. However she should include in the "Additional Information" box a note explaining that although she received £40,000 of profits from the partnership this is taxable on Mr Y under the settlements legislation and has therefore been excluded from her individual return.

When completing the partnership return this needs to show overall partnership profits of £80,000. The partnership allocation should show £40,000 to Mr Y and £40,000 to Mrs Y. The partners should add a note to the "Additional Information" box explaining that the £40,000 attributable to Mrs Y is taxable on Mr Y under the settlements legislation and is being returned on Mr Y's individual SA return.

Example 22

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

Completing the SA return

As the settlements legislation does not apply all income should go in the normal boxes on the SA return.

Summary

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 will be liable to challenge under the settlements legislation.

When considering whether or not the settlements legislation applies it is worth remembering that Parliament introduced the settlements legislation to prevent individuals transferring their income to a relative or friend in order to avoid tax. It therefore follows that a simple test to indicate whether or not the legislation might apply is to consider whether the same arrangements would have been made with a third party at arms length.

Publication

This article will be published in the February 2004 edition of Tax bulletin. It is being made available now to assist people when completing their self assessment returns for 2003-04. The following from Tax Bulletin is reproduced here as it is relevant when considering this article:

Content

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