

The Court of Appeal gave its judgement in the case of Jones v Garnett (“Arctic Systems Ltd”) on 15 December 2005. The judgement was unanimously in favour of the taxpayer. However the House of Lords will hear HMRC’s appeal against that decision on 5 to 7 June 2007. Accordingly the Court of Appeal decision cannot be regarded as final.

Meanwhile however the Court of Appeal judgement represents the law as it now stands. The contents of this Guide do not therefore fully reflect the current view of the law. . The guidance will be revised when the case has been finally resolved.

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**A Guide to the  
Settlements  
Legislation for Small  
Business Advisers**

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## **1 Introduction**

- 1.1 This guidance brings together in one place all of the existing, and some new, Inland Revenue guidance on the application of the settlements legislation to small businesses. This guidance is intended for use primarily by tax practitioners and accountants.
- 1.2 This guidance contains some background and general principles on the settlements legislation, followed by some specific details on how the legislation applies to business situations. There is also guidance on completing the SA return, especially where the taxpayer / adviser does not agree the Inland Revenue's view of how the settlements legislation applies.
- 1.3 Annex A contains 21 examples of business situations where the legislation does apply and 10 where it does not, along with specific guidance on completing the SA return.
- 1.4 Annex B contains a copy of the settlements legislation at sections 660A to 660G Income and Corporation Taxes Act 1988 (ICTA 1988) for ease of reference.
- 1.5 Annex C contains an advance copy of the SA Helpsheets IR270 which will be available from April 2005. This has been updated to include some examples and contains both trust and non-trust guidance.
- 1.6 This guidance, and the examples it contains, are an expression of the views and practice of the Inland Revenue.
- 1.7 Throughout this guidance, unless otherwise stated, all references are to Income and Corporation Taxes Act 1988 (ICTA 1988).

## **2 Background**

- 2.1 The settlements legislation is anti-avoidance legislation intended to prevent an individual from gaining a tax advantage by making arrangements which divert his or her income to another person who is liable at a lower rate of tax or is not liable to income tax. Most commonly the legislation will apply where an individual seeks to divert income to members of their family or to friends. A good test of whether or not the legislation applies in a business situation is to consider whether the same payments would be made to a person who acquired shares in a company or a share of a partnership at arms length. Or whether income is being paid simply because the recipient is a spouse or child or some other individual the business person might wish to benefit.
- 2.2 The legislation was originally enacted in the 1930's and was brought up to date in 1995, further amended in 1999 and can now be found at sections 660A to 660G in Part XV of Income and Corporation Taxes Acts 1988. The legislation applies to many trusts but can also apply to other arrangements involving individuals, companies and partnerships. It is these non-trust situations which this guidance focuses on, although the general principles are the same in trust situations.

### 3 General principles

3.1 There are some general principles that apply for all situations where the settlements legislation can apply.

#### 3.2 Definitions

3.2.1 There are two key definitions in the settlements legislation, both set out in section 660G(1):

- **Settlement** includes any disposition, trust, covenant, agreement, arrangement or transfer of assets. (Case law has shown that a settlement may include a series of transactions which taken together are regarded as an arrangement.)
- **Settlor** means any person by whom the settlement was made.

3.2.2 Additional guidance on identifying a settlor is set out in section 660G(2):

*“A person shall be deemed for the purposes of this Chapter to have made a settlement if he has made or entered into the settlement directly or indirectly, and, in particular, but without prejudice to the generality of the preceding words, if he has provided or undertaken to provide funds directly or indirectly for the purpose of the settlement, or has made with any other person a reciprocal arrangement for that other person to make or enter into the settlement”*

3.2.3 There are some important statutory exemptions from the legislation:

- Section 660A(6) exempts an outright gift by one spouse to the other of property from which income arises, unless;
  - the gift does not carry the right to the whole of that income, or
  - the property given is wholly or substantially a right to income.
- Section 660A(9)(a) exempts income consisting of annual payments made by an individual for bona fide commercial reasons in connection with their trade, profession or vocation.
- Section 660A(9)(b) exempts certain donations made to charities.
- Section 660A(9)(c) exempts income consisting of a benefit under an approved pension arrangement.

#### 3.3 Arrangements

3.3.1 The expression “settlement” includes any arrangement. “Arrangement” covers a wide range of transactions or series of transactions. It is taken to mean not only an arrangement embodied in a formal document, or legal agreement, but also an arrangement where there are associated transactions only some of which may be expressed in a written agreement. It can include a single transaction or a series of

associated transactions where there is no formal written agreement at all.

### **3.4 The whole arrangement**

3.4.1 It is essential to look at the whole arrangement when considering whether the settlements legislation applies. This could include a series of transactions, some of which may be commercial or involve outright gifts between spouses. If the overall effect of the whole arrangement is to transfer income from one individual (the settlor) to, say, the settlor's spouse or unmarried minor children, the settlements legislation is likely to apply. Sometimes the whole arrangement will not be clear until sometime after the company, for example, is set up. So it might be necessary to wait until dividends or remuneration are paid before it is clear that the legislation applies.

### **3.5 Reciprocal Arrangements**

3.5.1 The legislation applies where individuals enter into reciprocal arrangements. For example if two brothers transfer some of their own income to each others' children, such that neither father provides funds for his own children. The overall effect is for both brothers to give up income and both sets of children to become entitled to income, so the legislation will apply.

### **3.6 Bounty**

3.6.1 As can be seen from above the definition of "settlement" or "arrangement" is very wide. The courts have limited the scope of a settlement to where there is some element of bounty, see *CIR v Plummer* [1979] STC 793 : 54 TC 1. Broadly, bounty is the provision of value without any corresponding quid pro quo, usually a gift or a transfer at less than full value. So, for example, someone giving away a right to future dividends for no consideration is a bounteous transaction. However, whether or not there is an element of bounty in a particular situation will be something that will be considered in all the circumstances of that case.

### **3.7 Outright gifts**

3.7.1 In accordance with section 660A(6) "settlement" does not include an "outright gift" of property, from which income arises, by one spouse to the other unless the gift does not carry a right to the whole of the income or the property given is wholly or substantially a right to income. Given that the simple transfer of assets for no consideration is within the definition of settlement at section 660G ICTA 1988, and the definition of "settlor interested" includes a benefit to a spouse, then without subsection (6) all income arising from assets transferred between spouses would be caught. Evidently that is not the overall intention of the settlements legislation. Thus section 660A(6) serves an essential purpose as it removes from the charge under section 660A income arising from outright gifts, between spouses, of assets that would otherwise be taxed under the legislation.

3.7.2 However, there may be circumstances in which what looks like a gift between spouses to which section 660A(6) might apply is not, because as part of a wider

arrangement, an interest or influence over the gifted property and/or the income it produces is retained by the settlor such that it is not an outright gift.

### **3.8 What happens when circumstances change year by year?**

- 3.8.1 Before section 660A applies there needs to be a settlement and that may not be evident on day one. Case law makes it clear that not all parts of the arrangement have to be in place or even contemplated at the outset for a settlement to exist (see *Crossland v Hawkins* [1961] 39 TC 493). This case also illustrates that income tax is an annual tax and the question whether there is income arising from a settlement is one to be asked in each tax year.
- 3.8.2 Where a settlement exists that will remain the case unless the arrangements come to an end. So, for example, a husband who owns 100% of a small company and grants preference shares to his wife, where those shares carry no voting rights and no assets in a winding up, has entered into an arrangement caught by section 660A. However, for section 660A to apply in a particular year there needs to be income arising from that settlement in that year. If no dividends are paid on the preference shares then clearly no income arises. However just because no income arises in, say, years 1, 2 and 3, does not stop the legislation from applying in year 4.
- 3.8.3 Similarly, where part of the arrangement is the settlor working for uncommercial rates of remuneration to provide funds for the settlement, then the level of remuneration will be a relevant factor. If the remuneration drawn in a particular year is fully commercial and modest dividends are paid representing a commercial return (such as might be paid to a third party investor) then it is possible that none of the dividends are income arising from the settlement.
- 3.8.4 It may be the case that the business grows so that over the years additional employees are taken on and turnover and profit both show a significant increase. Again it is necessary to look at the facts in each year and ask whether any income arises from the settlement. Taking a small company, and assuming that the new employees are paid arm's length salaries and none of the other arrangements have changed, the enhanced part of the dividend paid to the spouse could still be linked to the decision to pay uncommercial director's remuneration and would still be income arising from the settlement.
- 3.8.5 However in practice other things are also likely to change. Perhaps, the business growth has increased the involvement of the spouse who is now responsible for a good deal more administration than before. It may also be that salaries taken by husband and wife have become commercial. If the facts show that the business is a commercially run joint venture and the income flows reflect that, it is unlikely that any income will have arisen under a settlement.

### 3.9 Spouses and minor children

3.9.1 It is a common misconception that the settlements legislation applies only to arrangements involving a settlor's spouse or minor children. However, section 660A(2) makes it clear the settlor is treated 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 not necessary for the settlor's spouse or children to be the people to whom the income is transferred. If the settlor or their spouse retains an interest in the property then the legislation can apply.

3.9.2 When considering a spouse, 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. So, for example, in a service company it is usually the person with the specialist knowledge who retains the interest because they control the source of income even if the people who benefit are not the settlor's spouse or minor children.

### 3.10 Minor Children

3.10.1 Section 660A applies to arrangements where the settlor, or their spouse, retain an interest in the settlement. Section 660B applies to situations where income not caught by section 660A is paid or made available to a minor unmarried child of the settlor.

3.10.2 Where the settlement is on the unmarried minor child of the settlor, some or all of the income arising is deemed to be that of the parent for tax purposes if payments are made to or for the benefit of the child.

3.10.3 There is a £100 de minimis limit in section 660B(5) which means that so long as the income arising from all the settlements of one parent does not exceed £100 in any tax year, the legislation does not apply in that year. Once the £100 is exceeded all income, not just the excess over £100, is taxable as the income of the parents.

### 3.11 Summary of general principles

3.11.1 So, in general, the settlements legislation applies where an individual enters into an arrangement to divert income to someone else. So long as those arrangements are:

- bounteous, or
- not commercial, or

- not at arm's length, or
- in the case of an outright gift between spouses, wholly or substantially a right to income.

3.11.2 For unmarried minor children of the settlor, the legislation is extended to include arrangements where income is paid or made available to that child.

3.11.3 However in deciding if a settlement exists it is necessary to consider the whole arrangement including any reciprocal agreements. Finally if there is no income arising during the year then the legislation does not apply that year.

## **4 How the legislation applies to family company / partnerships.**

4.1.1 In exactly the same way as other methods of diverting income to another person can bring an arrangement within the ambit of section 660A, it can apply in situations where a company or partnership is used to the same effect. 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.

4.1.2 A very small percentage of the enquiries the Inland Revenue currently undertake each year involve the settlements legislation. The Inland Revenue seeks tax, interest and penalties in appropriate cases. It is not possible to provide a definitive list of the issues the Inland Revenue look for when deciding which cases to take up for enquiry, but some of the factors can include:

- Main earner drawing a low salary leading to enhanced profits from which dividends can be paid to shareholders who are friends or family members.
- Disproportionately large returns on capital investments.
- Differing classes of shares enabling dividends to be paid only to shareholders paying lower rates of tax.
- Dividends being waived so that higher dividends can be paid to shareholders paying lower rates of tax.
- Income being transferred from the person making most of the profits of a business to a friend or family member who pays tax at a lower rate.

4.1.3 There is a wide range of arrangements that can potentially be caught by the settlements legislation which do not involve a trust. Each case will depend on the facts but some of the most common situations are:

- Shares subscribed at par that carry only restricted rights.
- Shares given away that carry only restricted rights.

- Shares subscribed at par in a company by one person where the income of the company derives mainly from a different person.
- A share in a partnership gifted or transferred below value.
- Dividend waivers.
- Situations where dividends are paid only on certain classes of shares.
- Dividends paid to the settlor's minor children.

4.1.4 As indicated above, these are by no means definitive lists of situations to which the settlements legislation can be applied.

## 4.2 Special Commissioners Case – Jones v Garnett

4.2.1 An appeal before the Special Commissioners in this case was heard in the summer of 2004. The case received a lot of press coverage and the Special Commissions decision can be viewed at [www.financeandtaxtribunals.gov.uk](http://www.financeandtaxtribunals.gov.uk). The Special Commissioners decided the legislation can apply to an arrangement involving a company owned by a husband and wife where all the shares were ordinary shares to which they had individually subscribed.

4.2.2 The facts in this case are very similar to those in example 11 in annex A.

## 4.3 Shares

4.3.1 Shares in companies can take many forms. The High Court case of *Young v Pearce* [1996] STC 743 involved preference shares with restricted rights. That case made it clear such shares can form part of a settlement. The Jones v Garnett case, however, involved ordinary shares with no restricted rights. When considering whether the legislation can apply to a company it is necessary to look at the whole arrangement, as the legislation requires. The relevant questions include:

- 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?

4.3.2 All these issues must be considered and if the shares are being used as a vehicle for diverting income then the legislation may apply.

#### **4.4 Independent Taxation and the “Will of Parliament”**

4.4.1 Some concern has been expressed that the application of the settlements legislation to husband and wife companies ignores the will of Parliament when it enacted Independent Taxation. During the debates on Independent Taxation and the settlements legislation the then Chancellor made it clear the legislation would not apply to outright gifts between spouses. That remains the case.

#### **4.5 Dividend waivers**

4.5.1 Where a close company declares a dividend and one or more of the shareholders waives the dividend in circumstances where other shareholders may benefit, there may be an arrangement where the settlements legislation applies. In such cases the person making the waiver has indirectly provided funds for an “arrangement” or “settlement” by giving up a sum to which he or she is, or may become, entitled.

4.5.2 Not all dividend waivers are caught by the settlements legislation. 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. The following factors tend to indicate that the legislation is likely to apply.

- The level of retained profits, including the retained profits of subsidiary companies, is insufficient to allow the same rate of dividend to be paid on all issued share capital.
- Although there are sufficient retained profits to pay the same rate of dividend per share for the year in question, there has been a succession of waivers over several years where the total dividends payable in the absence of the waivers exceed accumulated realised profits.
- There is any other evidence, which suggests that the same rate would not have been paid on all the issued shares in the absence of the waiver.
- The non-waiving shareholders are persons whom the waiving shareholder can reasonably be regarded as wishing to benefit by the waiver.
- The non-waiving shareholder would pay less tax on the dividend than the waiving shareholder

4.5.3 This is by no means a definitive list of situations to which the settlements legislation can be applied.

## **4.6 Partnerships**

- 4.6.1 The creation of a partnership may be regarded as an arrangement for transferring income from a settlor to members of his or her family or friends. Where the incoming partner receives a share of profits out of all proportion to the contribution made to the partnership, the arrangement would include an element of bounty.
- 4.6.2 It has been argued that the unlimited liability of the partners means the settlements legislation cannot apply to partnerships. The Inland Revenue does 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.

## **4.7 Goodwill**

- 4.7.1 The value of goodwill in a company may be relevant in determining whether an outright gift of shares is substantially a right to income. Goodwill can be a valuable asset of a business and each case will depend on its particular facts. However, 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.

## **4.8 What is a disproportionate return on capital?**

- 4.8.1 One of the factors to consider 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 it is necessary to 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.

## **4.9 What is an uncommercial salary?**

- 4.9.1 One of the factors that might be relevant when considering whether the settlements legislation applies is whether an individual is drawing an uncommercial salary. In deciding what is uncommercial it is necessary to 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 you 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 that is likely to be an uncommercial arrangement.

- 4.9.2 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 it looks uncommercial if the spouse was in fact receiving £5,000 a year from the company.
- 4.9.3 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 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. If the answer is no then the legislation probably applies.
- 4.9.4 What individuals need to do here is to make a judgement on what is commercial and what is bounteous and return the figures accordingly. A consideration of what would be paid to an unconnected third party undertaking the same duties would give a good indication of whether or not it is commercial.

## **5 Completing the SA return**

- 5.1.1 As section 660C(1) & (1A) makes clear, 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.
- 5.1.2 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 F1 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.
- 5.1.3 It is also sensible for individuals to include suitable explanations in the “Additional Information” box. For example an individual actually receiving a dividend might not be required to include that dividend on the SA return as another person (the settlor) 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 the Inland Revenue might hold – for example from the company accounts.)

### **5.2 What if I am not certain what figures to return?**

- 5.2.1 Under self assessment taxpayers are expected to make an accurate return and the figures they enter must be both appropriate and reasonable. The Inland Revenue is, of course, entitled to open enquiries into any return either by random

selection or where the taxpayers figures appear incorrect or unreasonable. As stated elsewhere in this guidance a good guide to what figures should be returned is to consider what would have been paid to an individual, not connected to the settlor, entering into a commercial arrangement at arm's length. For example if the most that would be paid to an unconnected secretary working part time would be £5,000, but £45,000 has been paid because the secretary is also the settlor's wife then £40,000 should be returned as the settlor's income on his SA return.

### **5.3 What if the taxpayer disagrees with the Inland Revenue's view?**

- 5.3.1 This depends on whether the facts of the particular case are similar to those in the Jones v Garnett Special Commissioners case:
- 5.3.2 If the facts are similar to the Jones case but the taxpayer still thinks section 660A does not apply and self assesses in accordance with this view, then they should put an entry explaining the situation in the white space of the Trusts pages of the SA return at box 7.32 or in a covering letter. The entry needs to indicate that the return has been completed other than in accordance with the Inland Revenue guidance on the settlements legislation and that if it had been completed in accordance with that guidance the self assessment would have been increased.
- 5.3.3 For the 2003/2004 SA return, if the Inland Revenue consider the facts to be sufficiently similar to the Jones case to warrant awaiting the outcome of that appeal, and the appeal in the Jones case is not settled by 31 January 2006, then an enquiry may be opened pending the outcome of the appeal. If the appeal is settled in the Revenue's favour before 31 January 2006 and before a SA enquiry into a return has been opened then a taxpayer will be able to amend his/her self assessment.
- 5.3.4 If the facts are different to the Jones case, but similar to the other examples in this guidance, but the taxpayer still thinks the Inland Revenue is wrong and makes their self assessment return on the basis of their understanding of the law then they should make an entry explaining the situation in the white space of the Trusts pages of the SA return at box 7.32 or in a covering letter. The Inland Revenue will then decide whether or not to open an enquiry into that return. As explained above, the entry needs to indicate that the return has been completed other than in accordance with the Inland Revenue guidance on the settlements legislation and that, if it had been completed in accordance with that guidance, the self assessment would have been increased.

## 6 Summary

- 6.1 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 arrangements will be caught under the settlements legislation.
- 6.2 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. Take a step back and consider, "If I was making these arrangements with an independent third party would I be paying them these wages or dividends or sharing my partnership profits in this way? If the answer is no then the legislation probably applies.

## 7 Publication

- 7.1 This guidance gives the views of the Inland Revenue on this particular issue.
- You can expect that interpretations of the law contained in this guide will normally be applied in relevant cases.
  - Particular cases may turn on their own facts, or context, and because every possible situation cannot be foreseen, there may be circumstances in which the interpretation given here will not apply.
  - The examples given are for illustration purposes only and do not confine the scope of the settlements legislation to particular circumstances.
  - Nothing in this guide affects a taxpayer's right of appeal on any point.

## ANNEX A - EXAMPLES

### Examples where the settlements legislation does apply

#### Example 1 – Identifying who is the settlor

Mr X is the director and owns all the 150 issued ordinary £1 shares of X Ltd. X Ltd issues 100 new ordinary £1 shares which are acquired for £100 by the X Family Trust. The trust has been established for the benefit of Mr X's family by his father, Mr X Senior, who created the trust by settling cash of £100. Shortly after the issue of the new shares, a dividend of £100 per share is declared and paid and the trust receives dividends of £10,000. Mr X controlled the arrangement for the issue of the shares at par followed by the dividend. Mr X is therefore the true settlor of the settlement from which income of £10,000 arose. The original settlement of £100 to create the trust by Mr X Senior also makes him a settlor but is usually disregarded on de minimis grounds.

#### Completing the SA return

The £10,000 dividends are treated as Mr X's under the settlements legislation 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.

The trustees of the X Family Trust should not include any of the dividends received on their SA return, but a brief note in the "Additional Information" box explaining why would be sensible.

#### Example 2 – Reciprocal arrangements

Y Junior, who is 10 years old, owns shares in his parents' company that cost £10,000. The investment is said to be a gift from his uncle, Mr X. Enquiries reveal that Mr. X's daughter, who is 15 years old, has £10,000 invested in a building society account. The source of the deposit is said to be a gift from her aunt, Mrs. Y. Under such a reciprocal arrangement, Mr. X would be the settlor in respect of the settlement to his daughter and Mrs. Y would be the settlor in respect of the settlement to her son.

#### Completing the SA return

Mr X is taxable on any interest arising on the Building Society Account and that should be included on his SA return at boxes 7.4 to 7.6 on page T1 of his SA return and include a brief note in the "Additional Information" box.

Mrs Y is taxable on any dividends paid on the company shares. The dividends should be included in boxes 7.10 to 7.12 on page T1 of her SA return and include a brief note in the "Additional Information" box.

### **Example 3 – Not an outright gift to a spouse**

Mr X is the director and owns all the shares in a private trading company. New preference shares, which have rights only to income, are issued. The director gives these to his spouse, Mrs Y. A substantial dividend is declared and paid to Mrs Y. Because the settlement is wholly or substantially a right to income, the dividends paid to Mrs Y are treated as the income of Mr X. There is no outright gift.

#### Completing the SA return

The dividends paid to Mrs Y are taxed on Mr X and should be included on his SA return at boxes 7.10 to 7.12 on page T1. A brief note in the “Additional Information” box would also be sensible.

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

### **Example 4 – Look at the arrangements as a whole**

Mr X and Mr Y are solicitors in partnership. They create a limited company to carry out all the clerical and administrative work for the partnership. The company takes over the clerical staff from the partnership but it has few capital assets. Mr X and Mr Y fix the fee the partnership pays to the company. Mrs. X and Mrs. Y, the partners’ wives, acquire all the shares in the company for £10 each. The company makes a profit of £60,000 in the first year. It distributes this by dividend to Mrs. X and Mrs. Y. The arrangement effectively transfers part of the profits of the partnership to the partners’ wives. The dividends received would be caught by the settlements legislation and treated as the income of the partners.

#### Completing the SA return

The £30,000 of dividends received by both Mrs X and Mrs Y are taxable on Mr X and Mr Y respectively.

Mr X should include the dividend in boxes 7.10 to 7.12 on page T1 of his SA return and include a brief note in the “Additional Information” box.

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

The position for Mr Y and Mrs Y is the same as for Mr and Mrs X respectively.

### **Example 5 – Look at the arrangements as a whole**

Mr X is a consultant who sells his services through a company at a daily rate plus expenses. He owns all the shares the private family company through which he sells his services. The company receives all the income he generates. The company’s only

source of income is from work carried out by Mr X. It has insignificant capital assets. Mr X transfers his shares in the company to his wife by way of gift. His earnings in one year exceed £70,000 but he decides to draw only £40,000 salary. This leaves £30,000 profit for the company. The company then pays a dividend of £30,000 to Mrs. X. The arrangement effectively transfers part of Mr X's earnings to his wife. Under the settlements legislation the dividends are treated as the income of Mr X.

#### Completing the SA return

Mr X should include the £30,000 dividends in boxes 7.10 to 7.12 on page T1 of his SA return and include a brief note in the "Additional Information" box.

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

#### **Example 6 – Children – gift of shares from parent**

Mr. and Mrs. X each own 50 of the 100 issued ordinary shares in X Ltd. They each decide to give 10 shares to each of their children aged 12 and 15. The children each then hold 20 shares, 10 from each parent. The dividends paid to the children are treated as the income of their parents.

#### Completing the SA return

Any dividends paid to the children should be included in boxes 7.10 to 7.12 on page T1 of their parent's SA returns and they should include brief notes in the "Additional Information" boxes explaining why.

The children are not taxable on the dividends received by them but taxed on their parents.

#### **Example 7 – Children – company shares and a trust**

A director owns all the shares in a family company. He sets up a discretionary trust for his 10-year-old daughter and transfers 25% of his shareholding to the trustees. A dividend is paid and the trustees make a discretionary payment to the child. The payment from the trust to the child is treated as the income of the parent.

#### Completing the SA return

The discretionary payment by the trust is an annual payment but it is caught by the settlements legislation and is taxed on the parent. It goes on page T1 in boxes 7.1 to 7.3. A note explaining this should be included in the "Additional Information" box.

The child is not taxable on the payment from the trust and nor can they reclaim the tax deducted by the trustees from the payment.

### **Example 8 – Children and the £100 de minimis limit**

A father makes regular gifts of cash to his 14-year-old son who deposits the money in a building society account. The child's mother gives her son a holding of shares in the family company. The child has no other income.

In one year, the building society interest is £80 and the dividends received are £120. The building society interest is less than £100 so section 660B(5) means the income is not taxed as the income of the father. However, as the dividends exceed £100 all the dividends are treated as the income of his mother.

If either parent had made all the gifts, the full £200 would be treated as their income.

#### Completing the SA return

The £120 of dividends are taxed on the mother and she should include them in boxes 7.10 to 7.12 on page T1 of her SA return and include a brief note in the "Additional Information" box.

The son is not taxable on the dividends but is taxed (subject to his personal allowances and other income) on the building society interest of £80. If the son is a non-taxpayer he can reclaim any tax deducted at source by the building society.

### **Example 9 – Company with 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 10 – Company with 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 11 – Company with 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 12 – 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 13 – 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 14 – Dividends on certain shares**

As in example 13, 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 15 – 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 16 – 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 17 - Company with 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 - Company with 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 - Company with 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 – 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 21 – A Partnership**

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.

## **Examples where the settlements legislation does not apply.**

### **Example 22 – An outright gift to a spouse**

Mrs X owns a property that is let at a commercial rent to an unconnected third party. Mrs X transfers the property by outright gift to her spouse Mr Y who then receives the rents. Mrs X has no further interest in or rights over the property. The rents that Mr Y receives are not subject to the settlements legislation because Mrs Y has made an “outright gift” to her spouse. The rents are Mr Y’s income for tax purposes.

#### Completing the SA return

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

### **Example 23 – 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 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 24 – Company with 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 25 – Company with 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 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 Mr and Mrs N's SA returns.

## **Example 26 - Company with 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.

### **Example 27 – Company with 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 28 - Company with 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.

### **Example 29 – 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 30 – 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 31 – A partnership**

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.

## ANNEX B

### The settlements legislation sections 660A-660G ICTA 1988

#### **660A.- Income arising under settlement where settlor retains an interest.**

(1) Income arising under a settlement during the life of the settlor shall be treated for all purposes of the Income Tax Acts as the income of the settlor and not as the income of any other person unless the income arises from property in which the settlor has no interest.

(2) Subject to the following provisions of this section, 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.

(3) The reference in subsection (2) above to the spouse of the settlor does not include-

- (a) a person to whom the settlor is not for the time being married but may later marry, or
- (b) a spouse from whom the settlor is separated under an order of a court, or under a separation agreement or in such circumstances that the separation is likely to be permanent, or
- (c) the widow or widower of the settlor.

(4) A settlor shall not be regarded as having an interest in property by virtue of subsection (2) above if and so long as none of that property, and no derived property, can become payable or applicable as mentioned in that subsection except in the event of-

- (a) the bankruptcy of some person who is or may become beneficially entitled to the property or any derived property, or
- (b) an assignment of or charge on the property or any derived property being made or given by some such person, or
- (c) in the case of a marriage settlement, the death of both parties to the marriage and of all or any of the children of the marriage, or
- (d) the death of a child of the settlor who had become beneficially entitled to the property or any derived property at an age not exceeding 25.

(5) A settlor shall not be regarded as having an interest in property by virtue of subsection (2) above if and so long as some person is alive and under the age of 25 during whose life that property, or any derived property, cannot become payable or applicable as mentioned in that subsection except in the event of that person becoming bankrupt or assigning or charging his interest in the property or any derived property.

(6) The reference in subsection (1) above to a settlement does not include an outright gift by one spouse to the other of property from which income arises, unless-

- (a) the gift does not carry a right to the whole of that income, or
- (b) the property given is wholly or substantially a right to income.

For this purpose a gift is not an outright gift if it is subject to conditions, or if the property given or any derived property is or will or may become, in any circumstances whatsoever, payable to or applicable for the benefit of the donor.

(7) [Repealed]

(8) Subsection (1) above does not apply to income arising under a settlement made by one party to a marriage by way of provisions for the other-

(a) after the dissolution of annulment of the marriage, or

(b) while they are separated under an order of a court, or under a separation

agreement or in such circumstances that the separation is likely to be permanent,

being income payable to or applicable for the benefit of that other party.

(9) Subsection (1) above does not apply to income consisting of-

(a) annual payments made by an individual for bona fide commercial reasons in connection with his trade, profession or vocation; or

(b) qualifying donations for the purposes of section 25 of the Finance Act 1990, or

(c) a benefit under an approved pension arrangement.

(10) In this section "derived property", in relation to any property, means income from that property or any other property directly or indirectly representing proceeds of, or of income from, that property or income therefrom.

(11) In this section "approved pension arrangement" means –

(a) an approved scheme or exempt approved scheme;

(b) a relevant statutory scheme;

(c) a retirement benefits scheme set up by a government outside the United Kingdom for the benefit, or primarily for the benefit, of its employees;

(d) a contract or scheme which is approved under Chapter III of Part XIV (retirement annuities);

(e) a personal pension scheme which is approved under Chapter IV of that Part;

(f) an annuity purchased for the purchase of giving effect to rights under a scheme falling within any of paragraphs (a) to (c) and (e) above;

(g) any pension arrangements of any description which may be prescribed by regulations made by the Secretary of State.

(12) In subsection (11) above "approved scheme", "exempt approved scheme", "relevant statutory scheme" and "retirement benefits scheme" have the same meaning as in Chapter I of Part XIV.

### **660B.- Payments to unmarried minor children of settlor.**

(1) Income arising under a settlement which does not fall to be treated as income of the settlor under section 660A but which during the life of the settlor -

(a) is paid to or for the benefit of an unmarried minor child of the settlor ,or

(b) would otherwise be treated ( apart from this section ) as income of an unmarried minor child of the settlor

in any year of assessment shall be treated for all the purposes of the Income Tax Acts as the income of the settlor for that year and not as the income of any other person.

(2) Where income arising under a settlement is retained or accumulated by the trustees, any payment whatsoever made thereafter by virtue or in consequence of the settlement,

or any enactment relating thereto, to or for the benefit of an unmarried minor child of the settlor shall be deemed for the purposes of subsection (1) above to be a payment of income if or to the extent that there is available retained or accumulated income.

(3) There shall be taken to be available retained or accumulated income at any time when the aggregate amount of the income which has arisen under the settlement since it was made or entered into exceeds the aggregate amount of income so arising which has been-

- (a) treated as income of the settlor, or
- (b) paid (whether as income or capital) to or for the benefit of, or otherwise treated as the income of, a beneficiary other than an unmarried minor child of the settlor, or
- (bb) treated as the income of an unmarried minor child of the settlor, and subject to tax, in any of the years 1995-96, 1996-97 or 1997-98, or
- (c) applied in defraying expenses of the trustees which were properly chargeable to income (or would have been so chargeable but for any express provisions of the trust).

(3A) For the purposes of subsection (3)(bb) above-

- (a) the amount of a child's income that is subject to tax in a year of assessment is the amount ("the taxable amount") by which the child's total income for income tax purposes exceeds the aggregate amount of allowances that may be set against it; and
- (b) income arising under the settlement that is treated as income of the child is subject to tax to the extent that it does not exceed the taxable amount.

In this subsection "allowance" includes any deduction allowed against total income

(4) Where an offshore income gain (within the meaning of Chapter V of Part XVII) accrues in respect of a disposal of assets made by a trustee holding them for a person who would be absolutely entitled as against the trustee but for being a minor, the income which by virtue of section 761(1) is treated as arising by reference to that gain shall for the purposes of this section be deemed to be paid to that person.

(5) If in any year of assessment the aggregate amount of a child's relevant settlement income does not exceed £100, subsection (1) does not apply in relation to that income. A child's "relevant settlement income" means income paid to or for the benefit of, or otherwise treated as income of, that child which apart from this subsection would be treated as income of the settlor under subsection (1)

(6) In this section-

- (a) "child" includes a stepchild and an illegitimate child;
- (b) "minor" means a person under the age of 18 years, and "minor child" shall be construed accordingly; and
- (c) references to payments include payments in money or money's worth.

### **660C.- Nature of charge on settlor.**

- (1) Tax chargeable by virtue of this Chapter shall be charged
  - (a) in the case of income falling within subsection (1A) below, as if it were income to which section 1A applies by virtue of subsection (2)(b) of that section; and
  - (b) in the case of any other income, under Case VI of Schedule D
  
- (1A) Income falls within this subsection if it is-
  - (a) income chargeable under Schedule F;
  - (b) income to which section 1A applies by virtue of its being equivalent foreign income falling within subsection (3)(b) of that section and chargeable under Case V of Schedule D;
  - (c) a distribution in relation to which section 233(1) applies;
  - (d) a qualifying distribution whose amount or value is determined in accordance with section 233(1A);
  - (e) a non-qualifying distribution, within the meaning of section 233(1B);
  - (f) income treated as arising by virtue of section 249;
  - (g) income treated as received by virtue of section 421(1)(a)
  
- (2) In computing the liability to income tax of a settlor chargeable by virtue of this Chapter the same deductions and reliefs shall be allowed as would have been allowed if the income treated as his by virtue of this Chapter had been received by him.
  
- (3) Subject to section 833(3), income which is treated by virtue of this Chapter as income of a settlor shall be deemed for the purposes of this section to be the highest part of his income.

### **660D.- Adjustments between settlor and trustees.**

- (1) Where by virtue of this Chapter income tax becomes chargeable on and is paid by a settlor, he is entitled-
  - (a) to recover from any trustee, or any other person to whom the income is payable by virtue or in consequence of the settlement, the amount of the tax so paid; and
  - (b) for that purpose to require an officer of the Board to furnish to him a certificate specifying the amount of income in respect of which he has so paid tax and the amount of tax so paid.

A certificate so furnished is conclusive evidence of the facts stated therein.

- (2) Where a person obtains, in respect of an allowance or relief, a repayment of income tax in excess of the amount of the repayment to which he would, but for this Chapter, have been entitled, an amount equal to the excess shall be paid by him to the trustee, or other person to whom the income is payable by virtue or in consequence of the settlement, or, where there are two or more such persons, shall be apportioned among those persons as the case may require.

If any question arises as to the amount of a payment or as to an apportionment to be made under this subsection, that question shall be decided by the General Commissioners whose decision shall be final.

(3) Nothing in this Chapter shall be construed as excluding a charge to tax on the trustee as persons by whom any income is received.

**660E.- Application to settlements by two or more settlors.**

(1) In the case of a settlement where there is more than one settlor, this Chapter shall have effect in relation to each settlor as if he were the only settlor, as follows.

(2) In this Chapter, in relation to a settlor-

- (a) references to the property comprised in a settlement include only property originating from that settlor, and
- (b) references to income arising under the settlement include only income originating from that settlor.

(3) For the purposes of section 660B there shall be taken into account, in relation to the child of the settlor only-

- (a) income originating from that settlor, and
- (b) in a case in which section 660B(2) applies, payments which are under that provision (as adapted by subsection (4) below) to be deemed to be payments of income.

(4) In applying section 660B(2) to a settlor-

- (a) the reference to income arising under the settlement includes only income originating from that settlor; and
- (b) the reference to any payment made by virtue or in consequence of the settlement or any enactment relating thereto includes only a payment made out of property originating from that settlor or income originating from that settlor.

(5) References in this section to property originating from a settlor are references to-

- (a) property which that settlor has provided directly or indirectly for the purposes of the settlement; and
- (b) property representing that property; and
- (c) so much of any property which represents both property so provided and other property as, on a just apportionment, represents the property so provided.

(6) References in this section to income originating from a settlor are references to-

- (a) income from property originating from that settlor; and
- (b) income provided directly or indirectly by that settlor.

(7) In subsections (5) and (6) above-

- (a) references to property or income which a settlor has provided directly or indirectly include references to property or income which has been provided directly or indirectly by another person in pursuance of reciprocal arrangements with that settlor, but do not include references to property or income which that settlor has provided directly or indirectly in pursuance of reciprocal arrangements with another person; and
- (b) references to property which represents other property include references to property which represents accumulated income from that other property.

### **660F.- Power to obtain information.**

An officer of the Board may by notice require any party to a settlement to furnish him within such time as he may direct (not being less than 28 days) with such particulars as he thinks necessary for the purposes of this Chapter.

### **660G.- Meaning of "settlement" and related expressions.**

(1) In this Chapter-

"settlement" includes any disposition, trust, covenant, agreement, arrangement or transfer of assets, and

"settlor", in relation to a settlement, means any person by whom the settlement was made.

(2) A person shall be deemed for the purposes of this Chapter to have made a settlement if he has made or entered into the settlement directly or indirectly, and, in particular, but without prejudice to the generality of the preceding words, if he has provided or undertaken to provide funds directly or indirectly for the purpose of the settlement, or has made with any other person a reciprocal arrangement for that other person to make or enter into the settlement.

(3) References in this Chapter to income arising under a settlement include, subject to subsection (4) below, any income chargeable to income tax by deduction or otherwise, and any income which would have been so chargeable if it had been received in the United Kingdom by a person domiciled, resident and ordinarily resident in the United Kingdom.

(4) Where the settlor is not domiciled, or not resident, or not ordinarily resident, in the United Kingdom in a year of assessment, references in this Chapter to income arising under a settlement do not include income arising under the settlement in that year in respect of which the settlor, if he were actually entitled thereto, would not be chargeable to income tax by deduction or otherwise by reason of his not being so domiciled, resident or ordinarily resident.

But where such income is remitted to the United Kingdom in circumstances such that, if the settlor were actually entitled to that income when remitted, he would be chargeable to income tax by reason of his residence in the United Kingdom, it shall be treated for the purposes of this Chapter as arising under the settlement in the year in which it is remitted.

## ANNEX C

### IR 270: Trusts and Settlements – Income Treated as the Settlor’s

This Help Sheet will help you fill in the Trusts etc. Pages of your Tax Return if you are a settlor and

- you have retained an interest in a trust or settlement, or
- trust income or capital is held for the benefit of your minor (under the age of 18) unmarried child, or
- the trustees of a settlement made by you have (or are deemed to have) paid a capital sum to you.

The Notes on Trusts etc. in the individual SA return tell you how to include the income on your Tax Return.

#### DEFINITIONS OF “SETTLEMENT” AND “SETTLOR”

The word “settlement” here includes an actual trust. It also includes any disposition, covenant, agreement, arrangement or, for certain purposes, transfer of assets. Although this is a very wide definition, certain transactions are not regarded as settlements. These are:

- outright gifts of property between spouses, provided the gift carries the right to the whole of the income and the gift is not wholly or substantially a right to income only. A gift will not be an outright gift if it is subject to conditions, or if the property or its income can be applied for the benefit of the giver in any circumstances whatsoever
- settlements by one party to a marriage making provision for the other after the dissolution or annulment of the marriage, or while they are separated under an Order of the Court or under a separation agreement, or in such circumstances that the separation is likely to be permanent
- settlements consisting of annual payments made by an individual for bona fide commercial reasons in connection with their trade, profession or vocation
- settlements consisting of covenanted payments to charity • settlements in which one spouse allocates pension rights irrevocably or allocates to the other benefits under an approved pension arrangement
- settlements that do not contain an element of bounty.

A “settlor” is defined as any person by whom a settlement is made. A person will be deemed to have made a settlement if they have:

- entered into the settlement directly or indirectly, or

- provided or undertaken to provide funds directly or indirectly for the purpose of the settlement (see Example 1), or
- made a reciprocal arrangement with another person for that person to make or enter into the settlement (see Example 2).

## Exceptions

Because the words “in any circumstances whatsoever” are so wide there are certain circumstances in which you will not be treated as having an interest even though you may have. These are:

- where you give money to another person absolutely (in other words, you give up any rights or control over the money). That person could decide of their own accord to give the money back to you. You will not be regarded as having an interest because the person has complete freedom to do what they want with the money
- where your interest depends on the bankruptcy of some person who is, or may become, beneficially entitled to the trust fund or the income from the fund
- where your interest depends on the assignment of, or charge on, the trust property or its income by a person who is or may become beneficially entitled to it
- where, in the case of a marriage settlement, your interest depends on the death of the parties to the marriage and all or any of the children of the marriage
- where your interest depends on the death of a child of yours who would become beneficially entitled to the trust property or its income at an age not exceeding 25
- so long as someone is alive, and under the age of 25, during whose life the trust property and its income cannot be paid to, or applied for, the benefit of you or your spouse except if that person should become bankrupt or assign their interest or deal with it in such a way that someone else acquired the right to take the interest to satisfy or discharge some obligation, for example, the beneficiary borrows money from you and provides their interest as a security for repayment.

If you have any doubts about whether you have an interest under a trust or settlement made by you, you may wish to consult the trustees of the settlement who will also need to know the answer in order to determine their own tax liability.

If you do have an interest, then the trust income arising without deduction for the expenses of trustee(s) is taxable as part of your own personal income. If this increases the amount of tax you have to pay, you can claim a refund from the trustees of any additional tax you pay on such income. Ask your Inland Revenue office for a certificate to do this.

## Examples involving trusts

**Example 1** You give a sum of money to your brother to settle on your infant children. Your brother does so. Although your brother is the actual named settlor, you will be the real settlor because you have indirectly provided the funds.

**Example 2** You agree to settle a sum on your brother's children on condition that he settles an identical amount on your children. You will be the real settlor of your brother's settlement on your children and he will be the real settlor of your settlement on his children because each of you has made a reciprocal arrangement with the other.

## HAVE YOU RETAINED AN INTEREST?

If you, as settlor, have retained an interest in the settlement, the income arising is taxable as part of your own personal income. In general, you will be regarded as having retained an interest in property that forms part of a settlement if that property, any substituted property or the income from the property, can be paid to you or your spouse, or can be applied for the benefit of either of you in any circumstances whatsoever.

**Example 3** You settle funds on your granddaughter contingent on her attaining the age of 30. The settlement fails to say what is to happen to the property if your granddaughter dies under the age of 30. You will have an interest in the property because under trust law the settled funds will come back to you if your granddaughter dies under the age of 30. The capital can therefore be paid to you "in any circumstances whatsoever".

**Example 4** You settle funds on discretionary trusts for your children and remoter issue (grandchildren, etc.). The capital is given to such of the beneficiaries as are living on some particular date in the future. There are no other gifts of capital. You will have an interest in the property because the funds will come back to you if none of the beneficiaries is living on the chosen date.

**Example 5** You settle funds on discretionary trusts for your children and remoter issue. Included in the powers given to the trustees is a power to transfer the trust fund to the trustees of any other settlement whose beneficiaries include any of your children and remoter issue, even though other persons are also included. You will have an interest in the settled funds because the trustees could use the power to transfer the funds to another settlement of which you or your spouse is a beneficiary.

## Examples involving non-trust situations

### Example 6 – Issued shares with restricted rights.

You are a Director of and own all the issued shares in a company. You create a new class of B shares which carry no voting rights and no assets in a winding up. The company then issues the B shares to your spouse. Dividends voted on those B shares would be treated as your income rather than that of your spouse as the B dividends are from shares that are wholly or substantially a right to income. You should return those dividends at boxes 7.10 to 7.12 on page T1 of the SA return and include a brief note in the "Additional Information" box at 7.32. Your spouse 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.

### **Example 7 – Subscribed shares.**

You form a company to provide your services to a number of clients. The company's share capital is £2 consisting of 2 £1 shares. You are the sole director of the company, and your spouse is company secretary but takes no other active part in the company. From the beginning each of you 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
Your salary	10,000
Your spouse's salary	5,000
Dividends	70,000

Your spouse receives a salary for duties carried out as company secretary, but the whole arrangement whereby he/she invests £1 and in return gets a dividend of £35,000 is a settlement. 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 you to your spouse is substantially a right to income and the whole of the dividend is taxed on you.

£35,000 is treated as your income and you should return £35,000 at boxes 7.10 to 7.12 on page T1 of your SA return and include a brief note in the "Additional Information" box at 7.32. Your own dividends should be returned in the normal way. Your spouse 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.

### **Example 8 – Partnerships**

You are a sole trader. The only assets are some office equipment worth less than £1,000. The business is successful. You admit your spouse as a partner in the business and the partnership agreement provides for the to be shared equally. Your spouse does no work in the partnership and the partnership has no employees. Taxable profits for the year are £40,000.

This is an arrangement transferring income from one spouse to the other. This is a settlement and your spouse's share of the partnership profits will be deemed to be yours and taxable on you.

You are taxable on all the partnership profits so you should include this on your SA return. £20,000 should be returned as partnership profits in the normal way. The £20,000 that is deemed to be yours because of the settlement should be entered on page T1 in boxes 7.4 and 7.6. A note explaining this should be included in the "Additional Information" box at 7.32. Your spouse should not include this as income from the partnership on his/her tax return. However he/she should include in the "Additional Information" box a note explaining that, although he/she received £20,000 profits from the

partnership, this is taxable on spouse under the settlements legislation and has therefore been excluded from their individual return.

The partnership return should show the overall partnership profits of £40,000. The partnership allocation should show £20,000 to you and £20,000 to your spouse. The partners should add a note to the "Additional Information" box explaining that the £20,000 belonging to your spouse is taxable on you under the settlements legislation and is being returned on your individual SA return.

### **Example 9 – Dividend Waivers**

A company with few shareholders declares a dividend but a shareholder has waived his or her right to a dividend. There will be a settlement if other shareholders benefit as a result of this.

For example, you own 80 ordinary shares in H Limited. Your spouse owns 20 shares. The company makes a profit of £25,000. You waive your right to any dividend. The company then declares a dividend of £1,000 per share and your spouse receives a dividend of £20,000.

As a dividend of this amount could not have been paid from the company's profits on all the shares, your waiver enhanced the dividend paid to your spouse. This is a settlement and £16,000 of the dividend paid to your spouse (the proportion of the dividend you would have received without the waiver) is deemed to be yours and taxable on you.

You should return that £16,000 at boxes 7.10 to 7.12 on page T1 of your SA return and include a brief note in the "Additional Information" box. At 7.32. Your spouse should include only £4,000 of the £20,000 dividends on his/her 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 10 – Dividends on certain shares**

As in example 9, but in this case you own A shares and your spouse 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.

By not voting dividends on the A shares (which rank equally with the B shares) there is a settlement because 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 your spouse is deemed to be yours and taxable on you.

You should return that £16,000 at boxes 7.10 to 7.12 on page T1 of your SA return and include a brief note in the "Additional Information" box. At 7.32. Your spouse should include only £4,000 of the £20,000 dividends on his/her 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.

## Special provisions for non-domiciled settlors

If you are resident and ordinarily resident in the UK but are domiciled elsewhere, trust income which arises abroad is treated as yours only to the extent that it is remitted to the UK. The trustees will be able to advise you on this point.

## HOW TO RETURN YOUR TRUST MANAGEMENT EXPENSES (TMES) - actual trusts only

### Additional entries in boxes 13.1 to 13.3

If you had an absolute right to income but not capital from a trust, then only the part of the trust income used to meet trust expenses (“trust management expenses” or “TMEs”) allowed in arriving at your taxable income need to be deemed to be yours. That is because all the other income is already yours.

TMEs are treated as chargeable to Income Tax as follows:

- expenses up to the amount of the dividend income are treated as chargeable to tax at the dividend rate(s), **and**
- any expenses in excess of dividend income are treated as chargeable to income tax at the basic rate even if they are paid out of income chargeable at the lower rate.

To give effect to this you need to make entries in boxes 10.15, 10.16 and 10.17 and possibly boxes 13.1, 13.2 and 13.3.

Enter in box 10.15 the lower of:

- a. the trust management expenses you have deducted in arriving at the income included on your Return, **and**
- b. the amount of the trust dividend income.

Enter in box 10.17 the figure in box 10.15 multiplied by  $10/9$  . Enter in box 10.16 the figure in box 10.17 *minus* the figure in box 10.15.

You will need an entry in box 13.1 if the trust management expenses exceed the amount of the dividend trust income. If they do, enter the amount of the excess in box 13.1.

Where there is an entry in box 13.1 you will need to enter a figure in box 13.3 which is:

- the figure in box 13.1 multiplied by  $5/4$  , if the expenses have been met out of income which is chargeable at the lower rate
- the figure in box 13.1 multiplied by  $100/78$ , if the expenses have been met out of income which is chargeable at the basic rate
- the same figure as in box 13.1, if the expenses have, exceptionally, been met out of income which has not suffered UK tax (for example, because the trustees are non-UK resident).

Enter in box 13.2 the difference between boxes 13.3 and 13.1.

## **INCOME YOU SHOULD NOT INCLUDE IN YOUR RETURN**

There are exceptions to the general rule that if you have retained an interest in the settlement you are taxable on the income arising under the trust or settlement.

### **Settlor-interested trusts**

From 6 April 2000, if the trust gives money to charity out of income, exclude that income from your Return. **H**

If there is a discretionary payment to charity out of the trust's income, you should exclude that income, including a proportional amount of TMEs. For example, a trust receives £1,000 gross income, and pays £200 TMEs, and gives £100 to charity. You should exclude from your income ( $£100 + (200 \times 100/1000)$ ), that is, £120.

If the trust was required under the terms of the deed to pay a certain amount to a charity you should exclude that income. For example, a trust receives £1,000 gross income including £500 bank interest and £500 rent, and it is required to pay half of the income to charity. You should exclude £250 bank interest and £250 rent from your income. If instead the trust was required to pay all the bank interest to charity, you should exclude £500 bank interest from your income. You should also exclude a proportional amount of TMEs. So if the trust received income of £100 and was required to give half to charity, half the TMEs will be allowable against the half paid to charity.

### **Other settlements — interest free or low interest loans to charity**

Where you lend money, you are a settlor and retain an interest in the property. But from 6 April 2000, the law says that a “settlement” does not include an interest free or low interest loan of money by an individual to charity. Do not return interest waived by you on such loans, whether made before or after 6 April 2000.

## **SETTLEMENTS MADE BY YOU WHOSE BENEFICIARIES INCLUDE YOUR MINOR UNMARRIED CHILDREN**

In A, B and C below the term “child” means a child or stepchild of yours who is unmarried and under the age of 18.

### **A. Settlements made before 9 March 1999 (but excluding funds added to such settlements on or after 9 March 1999)**

Any income paid to or applied for the benefit of your child is treated as your income for tax purposes. Any sum paid to or applied for the benefit of your child will also be treated as your income if there is available income (as described aside) to match the payment.

### **B. Settlements made on or after 9 March 1999 and funds added on or after that date to settlements made before then**

1. If the terms of the settlement are such that the income would otherwise, before being distributed, be treated as your child's income, that income will be treated as yours for tax purposes. You will need to apportion the income on a just and reasonable basis in

the case of funds added on or after 9 March 1999 to an already existing settlement as it is only the income from the added funds which is treated as yours.

2. If the terms of the settlement are such that the income would not, before being distributed, otherwise be treated as your child's income any income treated as yours is computed in the same way as in A aside.

### **C. Simple gifts**

If you use your own money to: • purchase assets, **or** • open or add to a bank or building society account in your child's name, **or** • transfer an existing asset of yours into your child's name any income arising from the asset/account is treated as yours for tax purposes. But if you provide only part of the asset/account, only the income arising from that part is treated as yours.

### **Exception to A, B and C**

If the total income to be treated as yours under the above rules does not exceed £100 gross in any year, no part of it is treated as yours for that year.

### **Available income - minor unmarried children**

To calculate this, total the income arising each year since the settlement was made and then deduct from that total, income that:

- has already been treated as yours in an earlier year
- has been treated as that of a beneficiary other than a child or stepchild of yours who is unmarried and under the age of 18
- has been treated for any of the tax years 1995-96, 1996-97 and 1997-98 as that of a child or stepchild of yours who is unmarried and under the age of 18, but only to the extent that it would have been charged to tax on the assumption that the income had been received untaxed. If your child had no other income, the income on which he/she would have been charged will normally be the amount in excess of the child's personal allowance. If your child had other income, for the purposes of calculating how much settlement income would have been charged to tax, you may assume that settlement income is the top part of total income
- has been applied in meeting expenses of the trustees which were properly chargeable to income (or would have been so chargeable but for any express provision of the settlement).

### **LOANS PAID OR REPAYED TO YOU AND OTHER CAPITAL SUMS PAID TO YOU - actual trusts only**

An amount equal to the “available income” of a settlement (or the amount of the payment, if less) as described below in “**How to calculate available income - capital sums paid to you**” will be treated as your taxable income if the trustees:

- lend money to you or your spouse, **or**
- lend money to you or your spouse jointly with another person, **or**
- repay a loan to you or your spouse, **or**
- repay a loan to you or your spouse jointly with another person, **or**
- pay a sum to a third party at your direction, **or**
- pay a sum to a third party by virtue of an assignment by you of the right to receive it, **or**
- otherwise pay or apply a sum for your benefit, provided the sum is not fully paid for in money or money's worth.

If a **body corporate** connected with the settlement does any of the above things, it will be deemed to have been done by the trustees but only where the trustees have made an associated payment to that body corporate.

If a payment is made by or to a body corporate that is associated with another body corporate, the payments may be treated as paid by or to that other body corporate. If in doubt ask your Inland Revenue office or tax adviser for advice.

### **Definition of “body corporate connected with a settlement”**

A “body corporate” is connected with a settlement if it is a close company (or only not a close company because it is not resident in the UK) and the participators then include the trustees of the settlement.

An associated payment is:

- any loan or repayment of a loan to that body corporate by the trustees of the settlement, **or**
- any other sum or asset transferred to that body by the trustees that is not paid or transferred for full consideration in money or money's worth,

that is paid or transferred in the five years ending or beginning with the date on which the capital sum is paid to you.

### **How to calculate available income - capital sums paid to you**

You must first total the income that has arisen since the settlement was made. You then deduct the following amounts:

- 1 Sums paid (except those sums detailed below) by the trustees to any persons in such a way that they fall to be treated as income of those persons for the purposes of Income Tax or would be so treated if those persons were domiciled, resident and ordinarily resident in the UK and the sums had been paid to them there.

## Exceptions to 1

- a. payments of interest
  - b. payments made to bodies corporate connected with the settlement
  - c. payments made to another settlement made by the trustees or by you
  - d. payments that are treated as your income as a result of doing this calculation.
- 2 Any expenses (except those detailed below) of the trustees that, in the absence of any express provisions of the settlement, would be properly chargeable to income.

## Exceptions to 2

- a. any expenses included in the sums detailed above
- b. any interest paid for which no relief from tax is allowable under any provisions of the Income Tax Acts and which is not paid to you or your spouse
- c. any interest paid (not falling within b. above) in any year where the only sums paid in that year (falling within 1 above) were paid to you or your spouse
- d. a fraction of any interest paid, not falling within b. or c. above, calculated in any year using the fraction

$$A - B / A$$

where:

A is the whole of the income arising under the settlement in the tax year *minus* the expenses (apart from interest) detailed in 2 above

B is that part of the sums within 1 above that is paid to persons other than yourself or your spouse.

- 3 The amount of the income which has been used to frank or set against the payments to you or your spouse in earlier years.
- 4 The amounts of any previous payments to you or your spouse.
- 5 The amount of the income that has not been distributed, but that has been treated as yours because you have retained an interest.
- 6 Any sums paid under the settlement to the extent that they have been disallowed as deductions from your total income because the trustees have not distributed them.

- 7 Any sums paid to or for the benefit of your minor, unmarried children that are treated for tax purposes as your income.
- 8 That part of the settlement income that represents income from a close company for an accounting period beginning before 1 April 1989 and that has, or could have been, apportioned to a beneficiary.
- 9 An amount equal to tax at the rate applicable to trusts on
  - a the aggregate income arising under the settlement that has not been distributed, **minus**
  - b the aggregate amount of income and sums in paragraphs 5, 6, 7 and 8.

You can work out the amount of the undistributed income by deducting the figures in 1 and 2 from the total income arising. **HELP SHEET IR270**

### **How to measure the charge**

Once the amount of the available income has been calculated you need to compare that figure with the amount of the capital sum paid (or deemed to be paid) to you.

If the available income is greater than the whole of the capital sum paid to you, it is treated as your income. If the available income is less, it is that amount that is treated as your income. The balance of the capital sum is then carried forward and set against the available income of future years for a maximum 11 years or until the capital sum is exhausted.

The amount treated as your income is then grossed up at the rate applicable to trusts and charged to income tax. Credit is given for notional tax at the appropriate rate,

### **What is the appropriate rate?**

- For income which arose to NR trustees from a source outside of the UK  
**0%**
- Where the above does not apply the capital payment is matched with earlier income before later income.
  - In respect of any part matched with income arising before 6/4/04 the rate is **34%**
  - In respect of any part matched with income arising on or after 6/4/04 the rate is **40%**

### **Complete repayment of loans –**

#### **Restriction of charge**

If the capital sum paid to you is a sum paid by way of a loan, then if the whole of it is repaid no part of it is treated as your income for any tax year after the one in which the repayment occurs.

**Repeated loans** Where you have previously received and wholly repaid loans, only the excess of any new loan over the amounts of the previous loans that have been treated as your income will be regarded as a capital sum.

**Repayment of loans to trustees** If:

1. you receive a capital sum from the trustees that is a complete repayment of a loan made to them by you, **and**
2. you subsequently lend to the trustees another amount not less than that capital sum received,

no part of the sum you received under 1 will be treated as your income for any tax year after the year in which you make the second loan.

**If a loan or capital sum has been paid to you as a settlor you should not use the boxes at 7.1 to 7.12 of the Trusts pages. You should show your calculation of**

- the amount chargeable to tax as a result of the loan or capital payment,
- the tax due on that amount, and
- the notional tax available for set off (if any)

**in the additional information box at 7.32 in the Trusts pages of the return.**

**Where your calculation in box 7.32 results in additional tax you will be unable to file the return by internet because the tax due will not be included automatically in our calculation. Instead include the additional liability in the sum at box 18.3 of the main return.**