New Year tax break

Paula Tallon reports on a Court of Appeal ruling last month which is good news for husband-and-wife practices

The decision handed down on December 15, 2005 in the case of Jones v Garnett was a victory for the taxpayer and a blow for HM Revenue and Customs (HMRC).

The Court of Appeal's decision was unanimous in that the legislation at the centre of the case had no apparent policy objective and its interpretation should not be extended beyond the existing case law – case law that has been around since 1939.

An announcement on January 13, 2006 confirmed that HMRC is not ready to go away yet and has decided to petition the House of Lords for leave of appeal against the decision. This does not mean that it will definitely go to the House of Lords, the Appellate Committee needs to decide whether to allow the appeal.

Taxpayers who submitted their tax return before the decision in the Court of Appeal and prepared it based on HMRC guidance need to amend their 2003/04 tax returns by January 31, 2006 or else they could lose thousands of pounds if HMRC is not successful in its petition.

THE CASE DETAILS

The case concerned IT consultant Geoff Jones and his wife, Diana, and a company they set up in 1992, Arctic Systems Limited.

On the advice of their accountants, the shares were issued as one share to Mrs Jones and one share to Mr Jones. This is common tax planning with family businesses.

The company was used to exploit the personal services of Mr Jones as an IT consultant. However, Mrs Jones did some work in the company. She undertook all the bookkeeping, liaised with the accountants and the bank, organised insurance, dealt with the contracts and other administrative tasks. She worked on average four or five hours a week on the company's business.

Both Mr and Mrs Jones received a salary from the company on which PAYE was accounted for. Mr Jones received £8,400 per year and Mrs Jones received £3,600 per year.

In 1999/2000 dividends of £25,767.25 were paid to each of the shareholders. HMRC assessed Mr Jones to tax in respect of the dividend paid to Mrs Jones on the grounds that there was a settlement within the definition contained in Section 660A (1) Income and Corporation Taxes Act 1988.

On the basis of this legislation the dividend paid to Mrs Jones was income arising under that settlement and was deemed to be the income of Mr Jones. Section 660A is re-enacted in Section 619 to 648 Income Tax (Trading and Other Income) Act 2005 (ITTOIA), following a rewrite of some of the Taxes Act.

Broadly, the settlements legislation is anti-avoidance which is intended to prevent an individual from gaining a tax advantage by making arrangements which divert his annual income to another person who is liable to tax at a lower rate.

In the case of Mr and Mrs Jones, HMRC claimed that by allowing Mrs Jones to be an equal shareholder and not drawing most of the income as a salary, Mr Jones had entered into arrangements which amounted to a settlement for the purpose of Section 660 ICTA 1988. Section 660 defines a settlement as 'any disposition, trust, covenant, agreement, arrangement or a transfer of assets'.

It was on this interpretation that HMRC assessed the dividends on Mr Jones. The Court of Appeal found in favour of Mr Jones, which went against the previous decisions by the Special

Commissioners and the High Court which both had found in favour of HMRC.

The Court of Appeal said that the subscription by Mrs Jones for her share was a normal commercial transaction so no settlement arose.

The Court also noted it was important that there was no contract or obligation for Mr Jones to provide his services to the company at an undervalue.

WHO IS AFFECTED?

This case concerns situations where a company is set up with the share capital owned between husband and wife or by people living together or who are closely connected, and one of the shareholders is the main income generator of the company. This is typical of personal service companies.

WHAT THIS MEANS FOR EXISTING COMPANIES

As a result of the previous High Court decision, many taxpayers in a similar situation to Mr and Mrs Jones may have been advised to prepare and submit their self assessment tax returns for the year ending April 5, 2005 based on the decision which has now been overturned by the Court of Appeal.

This could mean that one spouse is paying tax on the other spouse's income. If this is the case you could 'repair' the return based on the decision passed down on December 15, 2005.

For the 2004/05 tax return you have until January 31, 2007 to do this. Tax returns for 2003/04 should be amended by January 31, 2006.

However, as payments on account are based on the previous year, you may be making higher payments on account so you could make a claim to reduce these if you will not be 'repairing' the return before January 31, 2006.

If HMRC is granted leave to appeal and is successful in the House of Lords, interest will be charged on the unpaid tax. Speak to your accountant on how to do this. For taxpayers who self assessed on the basis that the case would be overturned, no action is needed on their returns.

On an ongoing basis, for individuals who are incorporating a limited company and wish to bring in a spouse (or civil partner) as a shareholder, they need to ensure that the spouse (or partner) subscribes for shares in their own right and pays for those shares (in many cases this will be a nominal value).

Also, the spouse providing the skills and services must not agree to provide these services at an undervalue to the limited company, namely there is no contract or any other arrangement in place to do so. If the company is set up in this way it does not constitute a settlement based on the existing legislation and the decision in the Court of Appeal.

WHAT NEXT FOR THE REVENUE?

The decision was a shock to HMRC, with the judge's comment that the 'lack of a clearly ascertainable legislative purpose underlines the need for caution in extending the concept of settlement beyond that the scope of existing jurisprudence' and that the HMRC's position in this case was a 'significant extension'.

In his opinion, this was a 'commercial situation between two adults, to which each is making a substantial commercial contribution, albeit not for the same economic value' and that 'such a difference by itself is not enough' to bring the case into the settlement provisions.

HMRC never thought it would lose this case and we all wondered what it would do next. The general opinion was that it would give up gracefully and perhaps introduce some new legislation in the 2006 Finance Bill.

Friday, January 13 gave us the answer. HMRC still has some fight and has announced its intention to petition, which will prolong the uncertainty for thousands of taxpayers.

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