

House of Lords warms the Arctic

by John Whiting, tax partner, PricewaterhouseCoopers LLP

Wednesday 25 July will undoubtedly be a day that has brought relief to many husband and wife businesses. Today the House of Lords has released its judgment in the long-running saga of the 'Arctic Systems' case (formally known as Jones v Garnett, Inspector of Taxes) and unanimously found in favour of the taxpayers. As the case was all about the extent to which Mr and Mrs Jones were able to organise their affairs tax efficiently, it is of widespread significance.

Background to the case

The Jones v Garnett (Arctic Systems Ltd) case concerns the tax treatment of a husband and wife owned company – the alleged ‘married couples business tax’. It has been a controversial and important case concerning the way small business income is taxed, with HM Revenue & Customs (HMRC) believing that unacceptable arrangements had been made in order to reduce the overall tax liability of the husband and wife concerned.

The company, equally owned by Mr and Mrs Jones, had a turnover of £91,000 for the year, derived from Mr Jones’s activities. Mr Jones drew a salary of £7,000, while his wife drew a salary for administrative work of £4,000, for which she worked approximately four hours per week. After expenses and corporation tax the couple shared the remaining £60,000 equally in dividends. As a consequence, the Jones’ paid less tax and national insurance contributions on their income, because they took dividends rather than salaries and a significant portion went to Mrs Jones to use up her lower tax rates.

Technical background

HMRC argued that Mr Jones’ actions in setting up the company allowing his wife to subscribe for a share and the general arrangements all constituted a settlement. Under s660A Taxes Act 1988, the income of a settlement, can be treated as that of the settlor (i.e. Mr Jones) in some cases, though not if the settlement was an outright gift to a spouse unless the property given is “wholly or substantially a right to income”. That important exception comes from subsection 6 of s660A.

HMRC has pointed out that this is not a test case, and it has argued that the s660A legislation has been in effect since the 1930s. However, the husband/wife issue only became relevant in the 1990s with independent taxation of a wife’s income. Some tax advisers believe s660A has not been used in this way before, but HMRC says that 20 to 30 such cases are pursued annually and it pointed to a 1995 case (Young v Pearce) as evidence, though that concerned the allocation to wives of preference shares in an existing company.

Progress through the courts

The Jones's first appeal to the Special Commissioners produced a finding in favour of HMRC and this was upheld at the High Court. However, the Court of Appeal found for Mr and Mrs Jones, saying that although there may have been an arrangement between the taxpayers (in setting up the company in the way they did) the arrangements didn't confer a

'bounty' at that stage, so there could be no settlement. Even if there was a settlement, it wasn't something that was 'wholly or substantially a right to income' as the share gave other rights and so the arrangement fell within the exclusion in S660A(6).

The House of Lords: was there a settlement?

The House of Lords decision is a careful and extensive one. Clearly they did not find this an easy case to decide and that perhaps is to be expected as they had agreed to HMRC's petition to hear the case.

The first issue that had to be decided is whether there was a settlement. As Lord Hoffman said, there has to be an 'element of bounty' in the transaction for there to be a settlement. Although he and his fellow Law Lords felt this was a rather old fashioned phrase, it was clearly at the hub of judicial precedent. Lord Hoffman, having examined the facts and precedents respectfully disagreed with Court of Appeal analysis, commenting that their finding that there was no element of bounty was "divorced from reality". He continued: "...Mrs Jones could not have been issued with a share without the agreement of her husband and when he agreed to that arrangement it was expected that he would take a low salary and that substantial dividends would be distributed. That was the advice which they had received from the accountant. And that was what happened."

He found support for this "...broad and realistic view of the matter..." in several cases, referring in particular to *Crossland v Hawkins*. At the end of the day, he felt that what had gone on between Mr and Mrs Jones was not a "...normal commercial transaction between two adults...it made sense only on the basis that the two adults were married to each other...". There was, therefore, the necessary 'element of bounty' and thus there was a settlement.

Lord Hoffman's colleagues agreed, Lord Hope commenting that this was a general issue, not something that was specific to the facts of this case. Lord Walker noted that an intention to avoid tax was not absolutely essential to the settlement legislation applying. Lord Neuberger also gave extensive analysis of the settlement issue and joined his colleagues in finding that a settlement did indeed exist.

What about the exclusion?

At that point, taxpayers might have become rather worried about the course of the decision. However, their Lordships then turned to the question of whether the gift was 'wholly or substantially a right to income' and the other factors in the exclusion within subsection 6 of S660A.

Interestingly, as far as the Lords were concerned, there was a distinct connection between there being a settlement and the possibility of the exclusion applying. If there was a settlement, that meant there had to be bounty involved and that in turn implied that there was a gift. Thus the taxpayers were at least through the starting point of the exclusion.

Lord Hoffman's analysis took three stages. Firstly, he accepted that there was a gift and it was outright. The second point was the Revenue's argument that the transfer of the share was not the whole of the arrangement as the arrangement included the provision of services by Mr Jones, the dividend policy and so forth. He felt that that argument was "...inconsistent with the argument by which HMRC have succeeded on the first point. The

transfer of the share was in my opinion the essence of the arrangement. The expectation of other future events gave that transfer the necessary element of bounty but the events themselves did not form part of the arrangement.”

Thus the taxpayers advanced down the exception get-out.

Lord Hoffman then turned to the third stage which was whether the share was 'wholly or substantially a right to income'. He accepted the taxpayer's contention – long argued for by bodies such as the Chartered Institute of Taxation – that as what was involved was an ordinary share, conferring a right to vote, participate in the distribution of assets etc., then it could not be just a right to income. There was a significant difference here between the ordinary share and the preference shares that were involved in the case of *Young v Pearce*. Those preference shares were indeed a right to income but here the share was not just a right to income; therefore the exclusion applied and the taxpayers succeeded.

In his judgment Lord Walker confessed to some difficulty in finding that the exclusion applied but accepted that it was possible that Arctic could build up a reserve of undistributed income. Baroness Hale, in her remarks, pointed to the build up of the husband and wife rules within the tax legislation and the exemptions available for spouses within inheritance tax and capital gains tax. Finally, Lord Neuberger came back to the connection between the two halves – that if there was a settlement, then that by implication meant there had to be a gift.

Conclusion

The result of the House of Lords judgment was unanimously in favour of the taxpayers. Accordingly, the very common arrangements, as practised by Mr and Mrs Jones, have been vindicated. That, of itself, removes a huge cloud from the minds of many couples and in turn vindicates the stance taken by practitioners and professional bodies.

It will mean that there is a need to recast HMRC guidance in this area and, of course, many people will be wondering whether HMRC will suggest that the law needs changing. In any event, the Lords judgment is not a free-for-all in terms of tax planning, being quite specific and there are lessons within it as to how the settlements legislation is to be applied. It should also mean that Mr and Mrs Jones can recover their costs (though they have been backed by the Professional Contractors Group and others), tear up their tax bill and get back to their real job of running an IT consultancy.