



The voice of freelancing

PCG Policy Briefing: S660A and Arctic Systems Ltd

Summary

- HMRC is wholly wrong, both morally and in law, to attack family businesses through the settlements legislation
- Despite HMRC's protestations to the contrary, this attack clearly represents an unlawful attempt by a Government department to reinterpret the law retrospectively
- PCG calls on HMRC to desist from its legal action in the Arctic Systems case and to acknowledge that the legitimate course of action would be to propose new legislation in full consultation with all relevant stakeholders
- Failing this, HMRC should at the very least acknowledge that the Arctic Systems case is a test case and agree to pay all further costs on this basis
- So far in the Arctic Systems case, one Special Commissioner and one High Court judge have agreed with HMRC's view; one Special Commissioner and three Court of Appeal judges have disagreed; consequently, it is not currently valid in law
- The House of Lords will hear the Arctic Systems Case in June 2007.

The Arctic Systems case

PCG has supported Geoff and Diana Jones, the owners of Arctic Systems Ltd, in taking their case to the Special Commissioners, High Court and Court of Appeal.

- Arctic Systems supplies the services of Geoff Jones to a succession of clients; Diana plays an extensive administrative role, dealing with financial matters, liaison with agents and potential clients and other issues
- From 1992, the Joneses ran the company in the standard way for businesses of this type, as recommended both by their accountant and, latterly, the DTI's Business Link website
- They ran their business without any challenge from the Revenue until 2003
- The challenge by the Revenue took the form of a demand for £42,000 in tax, back-dated over six years
- This demand could have cost them their home and at one stage looked quite likely to do so
- As has been seen in other cases, HMRC offered them a deal - in this case, to the effect that the bill for £42,000 would be reduced to a sum arrived at arbitrarily by the Revenue
- Geoff and Diana have had to face a protracted legal battle: it will have lasted at least three years by the time it is concluded.

This case has resulted in the ruling that the law does not say what HMRC has claimed it does and that it cannot levy tax on the basis of this invalid interpretation of the law.

- The Court of Appeal was in strong and unambiguous agreement with this view
- Lord Justice Keene said: "[I agree] that for a commercial venture such as existed in the present case to be brought within the scope of the settlement provisions would represent an unjustified extension of their scope."
- Lord Justice Carnwath said: "The Revenue's position in this case seems to me a significant extension. For the first time, they seek to apply the concept to what has been found to be a normal commercial transaction between two adults, to which each is making a substantial commercial contribution, albeit not of the same economic value."

HMRC stated, when announcing that they would seek leave to appeal: "The legislation... does not apply to income from those companies and partnerships that have normal commercial arrangements." The Court of Appeal found Arctic Systems to be a normal commercial arrangement: HMRC should therefore desist from its appeal.

What is S660A?

Very often, freelance contractors who are married will set up their company in joint ownership with their spouse. Alternatively, they may set it up in joint ownership with another person.

Commonly, one owner will earn money for the business by providing their services to clients; the other will typically have a role in administering the company's affairs.



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With the publication of Tax Bulletin 64 in April 2003, the position of the then Inland Revenue on this widely-used arrangement appeared to change, so that business practices that had been the norm since the introduction of the independent taxation of spouses in 1988 were suddenly deemed to be unlawful.

HMRC is claiming that, in this scenario, any dividends paid to the owner who does not earn the fees by providing their services should be taxed as if they were the fee-earner's income. This prevents the two owners using their tax allowances effectively by distributing dividends equally to each. The end result is therefore a substantial tax rise for businesses jointly owned in this way.

The legislation HMRC have been using to attempt this is Section 660A of ICTA 1988, part of the "settlements legislation", on the basis that the fee-earner is "settling" income on the non-fee-earner for reasons of tax advantage. In reality, the company is legitimately jointly-owned, and so no settlement in fact takes place.

This interpretation of the law is not currently valid: PCG funded the Arctic Systems case in which, in December 2005, the Court of Appeal found strongly against the Revenue. Unless and until further case law contradicts this, or new laws are passed, HMRC is unable to tax jointly-owned companies in this way.

In his Budget of 2005, Gordon Brown introduced a measure such that any couples who register under the Civil Partnerships Act will be taxed under the same provisions as married couples. While this document refers to married couples and spouses for convenience, everything in it applies equally to registered civil partners.

PCG position: retrospective application

Virtually all family businesses set up in the way that HMRC now seeks to attack were set up under long-standing professional accounting advice and in accordance with the recommendation of the Government's Business Link website. Despite its protestations to the contrary it is the clear view of the CIOT, the Tax Faculty of ICAEW, ICAS, ACCA, ATT, AAT, and virtually every taxation professional to have written or commented about this issue, that HMRC has changed its stance on this matter.

Even if the new interpretation of S660A were to be upheld by the House of Lords, PCG's position is that it is entirely unjustified to seek to apply this interpretation to arrangements in tax years prior to the release of Tax Bulletin 64 (April 2003), when HMRC's stance had not yet been formulated.

Business arrangements of the type attacked by HMRC were made possible by the introduction of the independent taxation of spouses in 1988.

- It was explicitly stated in the House of Commons at the time that business structures such as that adopted by Arctic Systems would be possible and, indeed, "desirable"
- The business structure later adopted by the Joneses quickly became a standard: it was for many years recommended not only by financial advisers but also by the Government's own Business Link website
- This would penalise tens of thousands of small businesses who have acted throughout in good faith and in accordance with the law as set out in statute
- It would also gain an estimated extra £1 billion of revenue for the Treasury, which was HMRC's original and sole motivation for attempting to reinterpret the law.

PCG is also deeply alarmed at the extreme difficulty in calculating of tax liability accurately under self-assessment regimes where detailed guidance is not available, and where tenuously defined concepts such as "commercial salary" are referenced (as in Tax Bulletin 64). Who is to decide the precise level of a "commercial salary", and without a precise figure how can tax liability accurately be evaluated? A self-assessment regime requires consistency, clarity and common sense. HMRC's stance on S660A is devoid of any of these qualities.

The Legal Arguments

i) HMRC's position on the application of settlements legislation to freelancers

There are two main scenarios in which a husband and wife own shares in their business and HMRC seek to apply the settlements legislation. In both cases the argument is that the dividend drawn by the spouse who does not earn fees should be recharacterised as the income of the spouse who does, leading to a potential higher rate tax liability.



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The first case is where both parties subscribe to shares when the company is set up. The capital introduced is typically no more than a few pounds and the company typically has a low book value (ignoring cash-in-hand). HMRC's view in this case is that the shares themselves have no value other than as a conduit through which tax-efficient dividends may flow. Looking at "the bigger picture", in HMRC's eyes, the source of funds is not the shares but the client work being done by (typically) one spouse.

Alternatively, one spouse subscribes to shares initially, but later gifts shares to the other spouse. Again the book value of the company (cash-in-hand excluded) is typically low and the work is carried out by one spouse. Such a transfer of assets is consistent with the law on CGT and IHT (as well as general matrimonial law) and, until the release of Tax Bulletin 64, the consensus view was that the outcome was not subject to the settlements legislation due to an exemption for gifts of anything that is not "wholly and substantially a right to income". HMRC's view is that in this case shares are in fact wholly and substantially a right to income.

ii) PCG position: ordinary shares are not "wholly and substantially a right to income"

Much of HMRC's argument on S660A in either of the above cases rests on the treatment of ordinary shares as a "right to income". This is at clear variance with established case law: ordinary shares carry full rights to capital, votes and dividends as well as responsibilities for the shareholder. The shareholder themselves cannot, except where the shareholding is a majority one, force there to be any "income" (through dividends) at all. In other contexts, such as share valuations, HMRC not only accept but require other rights to be taken into account. Other law gives ordinary shareholders rights which go substantially beyond income rights.

There is a separate situation where preference shares carrying no voting rights and no capital rights in a winding-up are issued. In this case PCG would not necessarily have a problem with the application of settlements legislation, where such application is consistent with advice and HMRC guidelines available during the tax years being assessed. But as far as ordinary shares are concerned, whether they have been gifted by one spouse to the other or subscribed to by both from the outset, they should clearly not be considered wholly or substantially a right to income.

iii) PCG position: initial subscription

Where husband and wife have owned shares from the start, PCG's position is simply that since no gift has taken place, the settlements legislation cannot apply; both partners take an equal risk on starting the business and are thus morally and legally entitled to equal reward from its success, in just the same way as the owners of any other business. Just as married couples buy cars and houses together and raise their children together, so it is normal for them to set up a company together; and their future livelihoods are equally bound up with the success of the company.