From me to you

PETER RAYNEY explains the tax advantages and possible pitfalls when dividends are paid to spouses or civil partners.

Since the introduction of independent taxation, many married couples (or civil partners) have made useful tax savings by structuring their affairs to ensure that both spouses use up their personal allowances and basic rate tax bands. In more recent times, this practice has become known as income splitting or income shifting.

For owner-managed companies, this strategy was considered to be a relatively easy one to implement. Typically, the husband could gift or issue an appropriate number of shares to their spouse. The company could then pay sufficient dividends that would result in little or no tax in the hands of that spouse.

As illustrated by ***Billie Jean***, it is possible for a spouse (with no other taxable income) to receive a net dividend of (say) £37,500 in 2014/15 without any tax liability.

Of course it's a settlement

Many "older" tax advisers will remember that the Inland Revenue (as was) began to resist arrangements that provided dividend income to spouses in owner-managed companies. It employed the settlements legislation as its fiscal weapon, even though this law dated back to the 1930s.

The landmark *Arctic Systems* case (*Jones v Garnett* [2007] STC 1536) taught us that it was not so easy after all. The case involved an important principle of tax law. It asked whether HMRC could overturn the payment of dividends to a spouse and treat them as her husband's income for tax purposes, thus negating the tax savings. Since *Arctic Systems*, we have seen further cases coming before the tribunals posing more or less the same questions.

In this case, the husband (Mr Jones) was responsible for earning all the profits on computer consultancy contracts, but drew a minimal salary only. Mr Jones was the sole director and chairman of Arctic Systems, which enabled him to control both the day-to-day and the strategic management of the company. However, the 50:50 share-owning structure gave the ability to pay large dividends to his wife (Mrs Jones).

The House of Lords had little difficulty in finding that Mr Jones *had* created a settlement in which his wife had an interest. Mrs Jones had acquired her shares at par (at a considerable under-value) and these "enabled her to receive dividends on the shares which were expected to be paid". It was concluded that this was not an arm's length transaction because "Mr Jones would never have agreed to the transfer of half the issued share capital, carrying with it an expectation of substantial dividends, to a stranger who merely undertook to provide the paid services which Mrs Jones provided".

This provided the necessary "element of bounty" for the arrangement to be a settlement (within what is now ITTOIA) 2005, s 620(1)). The settlement therefore fell within ITTOIA 2005, s 624. This provides that, where a person creates a settlement, but either they *or their spouse* (or civil partner) retains an interest in it, the income of that settlement is treated as belonging to them for income tax purposes.

Because the dividends were funded by Mr Jones's work, he was the settlor of the settlement. Mr Jones was treated as having a requisite interest in the dividend income because it was payable to his spouse.

We should just reflect on this point because it is often misunderstood in practice. Mr Jones did *not* win on the settlement point. *Arctic Systems* confirmed that any *gratuitous* transfer or issue of shares to a spouse is likely to be treated as a settlement; even though there is no formal agreement or trust document. There will, of course, be cases where shares are provided on a sufficiently commercially defensible basis so as not to constitute a settlement, as illustrated by *Patmore v HMRC* [2010] SFTD 1124.

Patmore strikes back

In the *Patmore* case, Mr and Mrs Patmore had purchased the shares of an engineering company for £320,000, with the first instalment of £100,000 being funded by a second mortgage on their home. Their accountant advised them to reorganise the company's shares into separate A ordinary voting shares and B non-voting shares. Mrs Patmore ended up with only 2% of the A shares and 10% of the B shares. The remaining shares of each class were owned by her husband. For a number of years, large dividends were paid to Mrs Patmore on her B shares, which she then passed to her husband to repay the outstanding debt for the original purchase of the company.

In HMRC's eyes this looked like a settlement. It argued that Mr Patmore had used his control of the company to pay these dividends to enable his wife to benefit from a lower tax charge. HMRC therefore sought to tax Mr Patmore (as the settlor) on the B share dividends received by his wife.

However, the couple's adviser indicated that the A and B share structure gave the required flexibility to pay dividends to Mrs Patmore without necessarily paying dividends to her husband. Furthermore, it was stressed that this reflected Mrs Patmore's higher risk on the mortgage liability because she had no daily involvement in the company.

The tribunal judge, Barbara Mosedale, considered that the tax efficiency of the share structure was not a significant factor because the legislation did not impose a "motive" test. Following Lord Hoffmann's approach in *Arctic Systems* case, she concluded that the courts should take "a broad and realistic view of all the arrangements in settlements-related cases". She concluded that HMRC had not done so in this case.

Although HMRC agreed that Mrs Patmore had a joint and equal responsibility for the debt incurred on the purchase of the company, Judge Mosedale found that this analysis was not followed to its logical conclusion: this being that Mrs Patmore was entitled to half of the acquired shares and an "appropriate share of the dividends".

Somewhat helpfully, the judge concluded that there had been an inequitable division of the A ordinary shares between the couple. Mrs Patmore should have had 50% of the A shares but ended up with a very small shareholding; this meant there was a constructive trust in her favour. The shares allocated to Mrs Patmore did not reflect the amount of her original investment in acquiring the company. Thus, there was no bounty from Mr Patmore and hence no settlement had been created for tax purposes. Interestingly, the judge resolved matters by allocating the dividends declared on all classes of shares between the couple on an "equal" basis.

The outright gift exemption

Back to *Arctic Systems* and the Joneses. Although there was a settlement, the Law Lords found in the taxpayer's favour because they held that the important "outright gifts" exemption (in what is now ITTOIA 2005, s 626) for inter-spousal settlements applied. This exemption had been introduced as part of the independent taxation reforms in 1990, specifically to enable spouses to make outright gifts to each other without fear of the settlement rules being applied.

This valuable escape clause applies where there is an outright gift of assets that does *not* represent an entire or substantial right to income. In *Arctic Systems*, the Law Lords held that the ordinary shares provided to Mrs Jones were more than a pure right to income – they had a bundle of rights, including the right to attend and vote at general meetings, rights to capital growth on a sale, and to obtain a return of capital on a winding-up.

The key conclusion emanating from the *Arctic Systems* judgment was that, although the shareholding arrangements constituted a settlement, they were exempted under the outright gifts clause. Thus, as long as a spouse (or civil partner) is given ordinary shares (carrying the normal full range of rights), any dividends paid on the shares should be treated as their income and the settlements legislation would not apply. Many advisers prudently recommend that dividends paid to a spouse should be paid into their own separate bank account (as opposed to the couple's joint account).

It is perhaps worth noting that HMRC did not take its loss in the House of Lords very well. In fact, almost before the ink was dry on the judgment, the Treasury told us that such arrangements were "unacceptable and unfair" and it was therefore going to introduce legislation to counter such income splitting or income shifting practices. However, attempts to introduce anti-avoidance legislation were quickly derailed in the face of opposition by the professional bodies and industry groups. Probably as a result of this collective resistance, the last Labour government moved income splitting on to the "back-burner".

Avoid dodgy preference shares

The conclusion reached in *Arctic Systems* may well have been different if Mrs Jones was given (say) non-voting preference shares instead. The taxpayers in *Young v Pearce* [1996] STC 743 had previously come unstuck on this point.

In that case, the High Court held that non-voting preference shares carrying a coupon of 30% of the company's net profit (which would be paid if agreed by the board) were wholly or substantially a right to income (since the other rights were minimal). The company's arrangements to provide spouses with the non-voting preference shares constituted a settlement, but this was not protected by the outright gifts exemption because essentially they were mainly a right to dividend income.

KEY POINTS

- Splitting income between spouses or civil partners can be an effective tax-saving device.
- A reminder of the lessons from the *Arctic Systems* case.
- The *Patmore* case and separate classes of shares.
- Distributable profits and the danger of dividend waivers.
- Dividends for children, other family members and unconnected parties.

BILLIE JEAN

Billie Jean is a 30% ordinary shareholder in her husband's company – Beat IT Ltd.

During 2014/15, she received a dividend of £37,500 and had no other income. In effect, Billie would receive the dividend tax-free, as shown below.

	£
Cash dividend	37,500
Tax credit (1/9th)	4,167
Gross dividend	41,667
Less: Personal allowance	10,000
Taxable income	31,667
Income tax at 10% (under BPR of £31,865)	3,167
Less: Tax credit (£4,167 but restricted to)	3,167
Tax liability	0

Thus, in practice, the safest way to avoid this trap is to avoid restricting the rights of the shares issued to a spouse – eg in terms of voting power or capital returns etc.

Problematic waivers

Dividend waivers can provide a legitimate way for one or more shareholders to waive their dividend entitlement to retain additional profits within the company. However, tax problems occur when waivers are used to distribute funds to shareholders on a "disproportionate" basis.

We have broadly concluded that the issue/transfer of ordinary shares to a spouse and the payment of dividends to them should be safe from HMRC challenge. However, this will not be the case where dividend waivers are used to provide a spouse with excessive dividends. By this, we mean the payment of a dividend that exceeds a spouse's pro rata dividend entitlement, based on the company's distributable reserves.

Numerous cases have confirmed that dividend waivers can fall within the settlement rules. HMRC's *Trusts Settlements & Estates Manual* (at para TSEM4225) provides an indication of the factors that HMRC will consider when determining whether to apply the settlements legislation. These are summarised as follows.

- 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.

Donovan and McLaren v HMRC

These principles were illustrated in the recent First-tier Tribunal decision in the case of *Donovan and McLaren v HMRC* [2014] UKFTT 048 (TC).

Mr Donovan (Mr D) and Mr McLaren (Mr M) each had a 50% shareholding in Victory Fire Ltd (VFL). In 2001, they agreed to issue a 10% shareholding in VFL to each of their wives. In subsequent tax years, dividends were paid to the four shareholders. However, Mr D and Mr M made annual dividend waivers, enabling their wives to receive a larger share of the total dividend than would have been due by reference to their 10% holdings. A comparison between the dividend entitlements and the actual dividend payments over the relevant years is shown in ***Donovan and McLaren***.

DONOVAN AND MCLAREN

Year ended 31 March	*Dividends paid £*	*Mr D's and Mr M's dividend entitlement (based on shareholding) each £*	*Dividends actually received by Mr D and Mr M each £*	*Mrs D's and Mrs M's dividend entitlement (based on shareholding) each £*	*Dividends actually received by Mrs D and Mrs M £*
2006	111,240	44,496	27,000	11,124	28,620
2007	117,240	46,896	28,200	11,724	30,420
2008	128,964	51,586	30,200	12,896	34,282
2009	112,500	45,000	30,200	11,250	26,050
2010	130,000	52,000	33,000	13,000	32,000

Thus, for example, in the year ended 31 March 2010, the wives each received £32,000 (24.6% of the total dividend) whereas they would have received only £13,000 (10% of the total dividend) on a normal dividend payout. HMRC argued that the settlements legislation applied to the dividend waivers, so that the arrangements were ineffective, ie as settlors Mr D and Mr M would also be taxed on the dividend income diverted to their wives.

The taxpayers appealed against HMRC's additional assessments, but their appeals were rejected on the following grounds.

- The taxpayers' contention that the waivers were motivated by commercial reasons was not convincing. The dividend waivers were clearly intended to take advantage of the wives' lower income tax rate bands to make an overall saving.
- The settlement rules can apply where there were arrangements that used a company's shares to divert income. There did not necessarily have to be a tax avoidance motive (see *Jones v Garnett* at paragraph 48). A key question was whether Mr D and Mr M would have entered into the relevant arrangements with a third party at arm's length.
- Based on the facts, the waivers would not have been made when dealing at arm's length with a third party. This therefore involved the necessary element of bounty, which is sufficient to create a settlement within ITTOIA 2005, s 620.
- The wives had clearly benefited from the dividend waivers. The dividend income was property in which Mr D and Mr M had an interest within the terms of ITTOIA 2005, s 625 because the income was payable to their wives.

Importantly, dividend waivers cannot fall within the spousal "outright gifts" exemption because they are simply a right to income. This was distinguished from the *Jones v Garnett* ruling because the essential arrangement here was *not* the allotment of the shares to the wives, but the waiver of the dividends.

It seems surprising that this case was contested because this is a classic case of how *not* to structure payment of the spousal dividends. The taxpayer was always going to lose because dividend waivers that give spouses more than they would be entitled to on a pro rata distribution of the reserves will always be a settlement involving a transfer of income. Because this involved a transfer of income, the "inter-spousal" outright gifts exemption was never going to be available.

Buck v HMRC

In the earlier case of *Buck v HMRC* [2008] SpC 716, the special commissioner, Sir Stephen Oliver QC, gave a similar ruling. In this case, Mr Buck (sole director) owned 9,999 out of the issued 10,000 ordinary shares. His then wife owed the other share. Mr Buck had waived his dividend entitlement for the years ended 31 March 1999 and 31 March 2000, which enabled the company to pay a £35,000 dividend to his wife for each year. The distributable profits at 31 March 1999 and 31 March 2000 were £46,287 and £46,694 respectively. Hence, the dividends paid to Mrs Buck would have been impossible without the dividend waivers. (In fact, without Mr Buck's dividend waiver, the company would have required around £300m of reserves to provide his wife with a dividend of £35,000 on her pro rata share.)

It was held that these arrangements were a settlement because they would not have been entered into had the individuals been acting at arm's length. The inference drawn from the facts was that Mr Buck waived his entitlements so that his wife could receive the dividend income. Furthermore, Sir Stephen Oliver also held that the outright gifts exemption did *not* apply in the case of a dividend waiver. There was no outright gift – merely a waiver of dividends (ie a right to income).

Waivers that work

As long as the above mentioned problems are avoided, there is no reason why dividend waivers should not be made in commercially justifiable cases. It is still important to follow the legal and practical requirements for a valid dividend waiver, such as the need to draw up a formal deed of waiver that is signed, dated, witnessed and lodged with the company. To be effective for income tax purposes, the dividend waiver must be executed before the right to the dividend arises. Briefly, interim dividends must be waived before payment. A waiver of a final dividend should take place before the shareholders approve the final dividend – often at the AGM. I generally counsel against repetitive dividend waivers each year. HMRC often look at the pattern of dividend waivers made regularly to determine whether there is a diversion of income as demonstrated by the *Donovan and McLaren* case. The use of different classes of shares to pay separate levels of dividend may be a more elegant solution.

Do separate classes work?

Some owner-managed companies use different classes of shares to provide greater flexibility with dividend payments between married couples (and, indeed, other family members). These arrangements, which typically involve two classes of shares (both of which rank pari passu), can work fairly well.

However, they do not automatically bypass the settlement rules. HMRC considers that it may be able to challenge certain arrangements involving the use of different classes of shares. For example, HMRC may seek to apply the settlement rules where the level of dividend paid on a particular class of share could *not* have been paid (by reference to the available reserves) without a bounteous arrangement to pay no or minimal dividends on the other class of shares (see HMRC's *Trusts, Settlements and Estates Manual* at TSEM4225, example 2).

Minors and other family members

Similar transfers and issues of shares to, and dividend waivers made in favour of, the settlors' *minor children* (or trusts for their benefit) would also be caught by the parental settlement rules in ITTOIA 2005, s 629.

It is worth noting that, had the *Arctic Systems* case involved the transfer or issue of shares to a *minor* son/daughter of the working-shareholder (as opposed to a wife), the tax outcome would have been completely different. On the facts, there would still have been a settlement for income tax purposes, but the outright gifts exemption would not have been available (because this is for spousal gifts only). The decision was therefore likely to have been that any dividends paid to the children (while under 18 and unmarried) would have been taxed on the parent-settlor shareholder. On the other hand, dividends paid to an adult (over 18) child of the settlor should be safe from attack.

Can the settlements legislation be applied to other members of the family or unconnected parties? The (then) Inland Revenue certainly considered this to be a possibility. The April 2003 *Tax Bulletin* (RI 268) at example 2, deals with a case involving "Aunt Jane" holding shares. This is based on the notion that the settlor's earning power is the property being transferred. The analysis is that the settlor's ability to withhold their services represents a retention of their interest in the settlement, which would therefore be caught by the basic "settlor-interested" settlement rule.

However, this line of thinking has subsequently been firmly rejected by Sir Andrew Park QC (as he is now) *in Jones v Garnett* [2005] STC 1667. In the High Court, he concluded that if Mr Jones's co-shareholder had been his sister, the settlement rules could *not* have applied. It should therefore follow that HMRC cannot use the settlements legislation to attack share transfers and subsequent dividend payments and dividend waivers made in favour of other family members and unconnected parties. The wording of the settlement code certainly supports this.

Income splitting can work

The *Arctic Systems* ruling remains as important as ever. Owner-managers can use their companies to pay tax-efficient dividends on ordinary shares to their spouses as long as they fall within the outright gifts exemption. For very profitable companies, spousal dividends might also be used to save tax at the top end of the income spectrum – eg where an owner-manager expects to have dividend income that would suffer an effective tax rate of 30.56%, all or some of it could be "diverted" to their spouse to be taxed at their effective dividend rate of 25%.

With proper planning, married couples should succeed in their income-splitting objectives by structuring their company shareholdings or dividend waivers on a sensible basis while taking care to avoid the numerous potential fiscal landmines. ■

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