

TAX

Arctic Systems and Income Shifting



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On 25 July 2007, The House of Lords found in favour of the taxpayers Mr & Mrs Jones in the widely publicised tax case known as "Arctic Systems".

Mr Jones supplied his services through a limited company Arctic Systems Ltd. The case considered whether under anti-avoidance law, dividends paid to his wife should be treated as if they formed part of his income, which would result in a higher rate of tax.

The Facts

Mr & Mrs Jones set up Arctic Systems Ltd and each subscribed for half of the shares.

Mr Jones was a computer consultant who worked full time for the company earning its income. Arctic Systems Ltd paid him a salary which was much lower than the income earned from its customers.

Mrs Jones kept the company records and generally dealt with the company paperwork for four or five hours a week for which she received a commensurate salary.

The majority of the profits were paid out as dividends to Mr & Mrs Jones.

The Revenue argument - A settlement has been created

The Revenue argued that the acquisition of the company and the transfer of a share to Mrs Jones, enabling her to receive the dividends, which were expected to be paid, was an arrangement. It was not a

transaction at arms' length 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. That provided the necessary "element of bounty" in the gift. The arrangement was to keep the entire income within the family but to gain the benefit of using up Mrs Jones's lower rates. The dividends paid to Mrs Jones arose under the arrangement. Mr Jones, by working for the company, provided it with the funds, which enabled the dividends to be paid. He was therefore a Settlor within the meaning of the Taxes Acts. As Mrs Jones was the spouse of Mr Jones, he was to be treated as having an interest in the income derived from her share and that income was therefore to be treated as his.

The Questions Tax legislation in respect of settlements does not apply to an outright gift by one spouse to the other of property from which income arises, **unless** the gift does not carry a right to the whole of that income, or the property given is wholly or substantially a right to income.

The questions to be decided were

- Had a settlement been created? and if so,
- Were the shares issued wholly or substantially a right to receive income?

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The Judgement

The House of Lords agreed with much of what the Revenue said.

The issue of the share to Mrs Jones contained an element of hope value in the expectation that Mr Jones would generate enough income for her to partake in the form of dividends. No independent third party would have been treated in the same way, so the shares were worth potentially more than the £1 Mrs Jones paid for them. Mr Jones was therefore giving up future income, although there were no contracts in place when the shares were acquired. The expectation from the start was that Mrs Jones would receive dividends. These elements showed that there was a bounteous transaction, which was a gift. A settlement had been created, but was limited to the setting up of the company with the intention to minimise tax.

In addressed the question of whether income producing ordinary shares were wholly or mainly a right to income. The Lords stated that although the value in the shares arose from the expectation it would generate income that is true of many shares, even in quoted companies. The share was not wholly or even substantially a right to income. It was an ordinary share, conferring a right to vote, to participate in the distribution of assets on a winding up, to block a special resolution etc. These are rights over and above the right to income.

The exemption for outright gifts between spouses therefore applied to the gift.

The Future

As expected, the Treasury was not happy with this decision.

A ministerial statement was issued stating that the case has brought to light the need for greater clarity in the law regarding its position on the tax treatment of what it describes as "Income splitting". "It is the Government view that individuals involved in these arrangements should pay tax on what is, in substance their own income and that the legislation should clearly provide for this. The Government will therefore bring forward proposed changes to the legislation to ensure that this is the case".

The full text of the judgement running to approximately 13,000 words is at Publications.uk

On 6 December 2007 a consultation document with draft legislation was published, reflecting the Government's avowed intention to reverse the effect of the Arctic Systems decision in situations where income is forgone in another's favour so as to reduce their joint income tax liability. This received such strong criticism that the proposals (which had been expected to be included in the 2008 Budget) were deferred. They were again deferred in the April 2009 Budget.

Specific advice should be obtained before taking action, or refraining from taking action, on any of the subjects covered

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