

Arctic Systems: Result and fall-out

by

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I. Introduction

At the end of his judgment in the case of *Jones v. Garnett*² Park, J., said, ‘I have given judgment at some length because there is widespread professional interest in this case, but I do not think that there is anything particularly novel or alarming in my decision. I believe that it is a simple application of well-established principles. Applying those principles, I dismiss the appeal.’³

Having come, with both his brother judges, to exactly the opposite conclusion, at the end of his judgment in the Court of Appeal Carnwath, L.J., said, ‘The lack of a clearly ascertainable legislative purpose underlines the need for caution in extending the concept of settlement beyond the scope of existing jurisprudence. The revenue’s position in this case seems to me a significant extension.’⁴

So clear were the judges in the Court of Appeal that their conclusion was the right one that they refused leave to appeal. So doubtful were the Appeal Committee of the House of Lords that they granted leave to appeal.

The House of Lords has now given its decision, five nil in favour of the taxpayer overall, but entirely against him on one of the two issues that arose.⁵ The Government’s response is that it will now consider legislation, presumably to reverse some of the effects of the decision. But it appears that there is no political will for more fundamental reform of the tax system as it affects either married couples⁶ or small businesses.⁷

² [2005] S.T.C. 1667 (Special Commissioners and High Court of Justice); [2006] 1 W.L.R. 1123 (Court of Appeal); [2007] 1 W.L.R. 2030 (House of Lords).

³ [2005] S.T.C. 1667, at 1711.

⁴ [2006] 1 W.L.R. 1123, at 1151.

⁵ [2007] 1 W.L.R. 2030.

⁶ For the purposes of this paper, the term ‘marriage’ includes ‘civil partnerships’; *mutatis mutandis*, the same applies to terms relating to marriage.

⁷ See G. Loutzenhiser, *Court of Appeal puts HMRC on ice*, [2006] B.T.R. 140, at 146.

II. The legislation

For the purposes of the case, the relevant legislation is contained in the Income and Corporation Taxes Act 1988 ('the 1988 Act'), as in force for tax year 1999 / 2000.⁸

Section 660A of the 1988 Act provided *inter alia*:

'(1) Income arising under a settlement during the life of a settlor shall be treated for all purposes of the Income Tax Acts as the income of the settlor and not as the income of any other person unless the income arises from property in which the settlor has no interest.'

The basic device this seeks to prevent is a person putting assets into trust in order to avoid paying tax on the income those assets produce.

The provision continued:

'(2) Subject to the following provisions of this section, a settlor shall be regarded as having an interest in property if that property or any derived property is, or will or may become, payable to or applicable for the benefit of the settlor or his spouse in any circumstances whatsoever.'

So if I establish a trust and make my wife⁹ a beneficiary, I shall be deemed to have an interest in the trust property and the trust income shall be treated as if it is mine.

There was an important exception:

'(6) The reference in subsection (1) above to a settlement does not include an outright gift by one spouse to the other of property from which income arises, unless—

- (a) the gift does not carry a right to the whole of the income, or
- (b) the property given is wholly or substantially a right to income.

For this purpose a gift is not an outright gift if it is subject to conditions, or if the property given or any derived property is or will or may become, in any circumstances whatsoever, payable to or applicable for the benefit of the donor.'

⁸ The provisions have since been replaced by sections 620 ff. of the Income Tax (Trading and Other Income) Act 2005. This has been done in the course of the Tax Law Re-write Project.

⁹ This does not apply if settlor and beneficiary are merely living together.

So, one can give an income-producing asset (for example, shares) to one's spouse, with the effect that the income from it is taxed in the hands of the spouse; but if what one gives is merely the right to income (for example by assigning one's right to dividends) one does not escape the effect of the settlements legislation. The income is still taxed as if there had been no assignation.

One might ask how it comes about that a settlement might be thought to include an outright gift to a spouse: the structure suggested by the word 'settlement' is that of a trust.¹⁰ However, in this context 'settlement' has an extended meaning. Section 660G of the 1988 Act provides:

'(1) In this Chapter—

“settlement” includes any disposition, trust, covenant, agreement, arrangement or transfer of assets, and

“settlor”, in relation to a settlement, means any person by whom the settlement was made.’¹¹

The courts having held that the particular examples of transactions identified in the definition of 'settlement' are not to be restricted in scope to things that are of the nature of a settlement.¹² So the concept of a 'settlement' is much broader than that of trust, and includes a straightforward gift. Were it not for the exception for gifts to spouses, if I gave

¹⁰ See [2005] S.T.C. 1666, at 1687, paragraph 102.

¹¹ Exactly this definition has appeared in various Taxes Acts since 1938, albeit initially in relation only to settlements in favour of children: Finance Act 1938, section 21(9)(b); Income Tax Act 1952, section 403; Income and Corporation Taxes Act 1970, section 444(2)); Income and Corporation Taxes Act 1988, section 670. Previous Taxes Acts included similar definitions in relation to settlement in which the settlor retains an interest, but omitting reference to a transfer of assets: Finance Act 1938, section 41(4)(b); Income Tax Act 1952, section 411(2); Income and Corporation Taxes Act 1988, section 681(4). The definition was unified by changes made to ICTA 1988 by Finance Act 1995, section 74 and Schedule 17, paragraph 1.

¹² *Thomas v. Marshall* [1953] A.C. 543. In that case, the issue was whether an absolute gift of money and gilts could be a 'settlement' within the meaning of section 21 of the Finance Act 1936, a predecessor of section 660G of ICTA 1988, notwithstanding that there was no separation of legal and beneficial ownership. The House of Lords held that it could: see in particular per Lord Morton of Henryton, at 554.

my wife some shares I would have to pay tax on the dividend income she received as if it were mine.

It may be mentioned at this stage that because of the breadth of the definition of the term ‘settlement’, and despite indications in early cases,¹³ the courts have found it necessary to set up some criterion to restrict the scope of the provisions. Otherwise, they would cover a large number, if not almost all, ordinary commercial transactions.¹⁴ Having held that they could not achieve this aim by restricting the meaning of the types of transactions identified,¹⁵ or by reading in an exception for *bona fide* commercial transactions,¹⁶ they have elected for the criterion of ‘bounty’.¹⁷ The meaning of this criterion in turn was one of the main issues raised in *Jones v. Garnett*.

¹³ See, for example, *Hood Barrs v. Commissioners of Inland Revenue* (1946) 27 T.C. 385, at 400 per Lord Greene, M.R.: ‘The mischief at which taxing Acts very often aim at is the mischief that the Revenue is not obtaining from certain types of transactions all the revenue it would like to obtain. Therefore, it is quite common to find that the net is progressively spread wider and wider. I find nothing in the limited scope of the [Finance Act 1922] enabling me to limit in any way what appears to me to be the plain language of the [Finance Act 1936].’; and also *Thomas v. Marshall* (cited above, note 9), in particular per Lord Morton of Henryton at 556: ‘I can find no context here which should lead your Lordships to give, for instance, the words “transfer of assets” any meaning other than that which they ordinarily bear, or to infuse into them some flavour of the meaning ordinarily given to the word “settlement”.’ Having said that, the element of bounty was clearly present in both those cases, in which a father simply gave money to buy shares (*Hood Barrs*), and money and gilts (*Thomas*), to his children.

¹⁴ See in particular *Inland Revenue Commissioners v. Plummer* [1980] A.C. 896, at 911 per Lord Wilberforce, and at 923, per Lord Diplock.

¹⁵ An exception to this is to be found in what is the only Scottish case on the settlements legislation, *Commissioners of Inland Revenue v. Morton* 1941 S.C. 467, in which the term ‘settlement’, having regard to the transactions the statute deemed it to include, was interpreted simply by reference to the meaning of the term ‘settlement’ at common law, namely ‘a charging of the property of the settlor with rights constituted in favour of others’: per Lord Moncrieff, at 480. So far as any purpose of tax avoidance was concerned, the only point made was that any gaps in the legislation should not be filled in so as to bring within its scope any transaction whose purpose was tax reduction: see per Lord Fleming, at 476. But the idea of interpreting the specific instances referred to in the definition of ‘settlement’ by reference to what the word ‘settlement’ normally means was clearly rejected in England in 1946: *Hood Barrs v. Commissioners of Inland Revenue* (cited above, note 10), in particular at 401 per Lord Greene, M.R.

¹⁶ First floated in *Copeman v. Coleman, for Coleman Minors* [1939] 2 K.B. 484.

¹⁷ The criterion was chosen definitively by the House of Lords in *Inland Revenue Commissioners v. Plummer* (cited above, note 11). In that case the tax-saving device was the purchase by a charity of an annuity from the taxpayer. The transaction was circular: its sole purpose, and its principal effect, were simply to reduce tax. But the charity paid full value for the annuity. So the sharp issue in that case was whether the criterion limiting the scope of ‘settlement’ was, on the one hand, bounty, or, on the other, *bona fide* commercial purpose. The House of Lords held the former, and the scheme escaped the application of the settlements legislation.

III. *Jones v. Garnett*

A. *The facts*

The facts in *Jones v. Garnett* are a fairly common occurrence,¹⁸ at least since independent taxation of spouses was introduced in 1988,¹⁹ and certainly following the introduction of the 0% starting rate of corporation tax in 2000²⁰ (now abolished²¹).

Mr Jones was an I.T. professional. He was made redundant in 1992, and decided to set up business as a consultant. At the time, his wife did not work, having left a successful career in catering management to start a family. Mr Jones's client market would engage only companies to provide outsourced services. So Mr Jones had to incorporate. Mrs Jones, being the one with all the experience in managing a company, agreed to deal with all the financial and administrative arrangements and to act as company secretary. What then happened was that Mr and Mrs Jones purchased an off-the-shelf company from nominees, each paying £1 for one share in the company. The reason each acquired one share was that their accountant advised that this was the standard way of doing things in this type of situation and that entitlement to dividends depended on ownership of shares. Mr Jones was aware that if some dividends were paid to Mrs Jones, the overall tax payable would be less than if all the dividends were paid to him. And so it proved. As the sole director, Mr Jones was entitled to refuse to register any transfer by Mrs Jones of her share; but it was accepted that he would not refuse such registration. In his words, she could do what she wanted with her share. So she could realise her investment at any time.

¹⁸ See in particular per Sir Andrew Morritt, C., [2006] 1 W.L.R. 1123, at 1145: 'the increasing tendency for married couples to be involved in the business of each other on a commercial non-bounteous basis'.

¹⁹ Finance Act 1988, section 32, repealing section 279 of ICTA 1988 with effect from tax year 1990/91. This point was used by Park, J., by implication, as explaining the absence of any previous attempts by the Revenue to apply the settlements legislation to this type of structure: [2005] S.T.C. 1666, at 1709.

²⁰ By Finance Act 1999, section 28, inserting section 13AA into ICTA 88.

²¹ Finance Act 2006, section 26.

It may be emphasised that although, once the decision had been made to incorporate, the potential for tax reduction was the principal reason for each spouse having one share, the decision to incorporate was motivated by purely commercial concerns.²²

All the services the company provided to third parties were provided by Mr Jones. He worked full time. Mrs Jones worked for the company for four to five hours each week. Each was paid a salary. The salary paid to Mrs Jones was a reasonable market rate for what she did, and was always within her personal allowance. Neither income tax nor any national insurance contributions were required. The salary paid to Mr Jones was ‘plainly far less than his expertise was able to generate for the company’. Indeed, it never even got much into Mr Jones’ basic rate band.²³ This enabled the company to pay much larger dividends than would have been possible if Mr Jones had drawn an appropriate salary, and much larger dividends than represented a normal commercial return on an equity investment of £1.

The reports do not make clear exactly how much tax was saved, but HMRC assessed the Jones to tax as if the dividends paid to Mrs Jones were income of Mr Jones, on the basis that those dividends were income arising under a settlement of which Mr Jones was the settlor, and even if it could be regarded as an outright gift by Mr Jones to Mrs Jones, the property given was wholly or substantially a right to income. This resulted in more tax being due. Mr Jones appealed against this assessment.

²² See in particular [2005] S.T.C. 1667, at 1689.

²³ Except for two years, not the subject of the appeal, in which, for reasons relating to concerns about IR35, Mr Jones was paid a reasonable commercial rate.

It is clear that the diversion of employment income could constitute the provision of funds into a settlement.²⁴ Accordingly, the two main questions with which the courts have had to grapple in this case have been whether there was a ‘settlement’, and, if so, whether the exception for an outright gift to a spouse not consisting wholly or substantially in a right to income applied.²⁵

B. The lower decisions

By dint of the chairman’s casting vote, the Special Commissioners decided in favour of the Inland Revenue.²⁶ In the High Court of Justice, Park, J., dismissed the taxpayer’s appeal.²⁷ The Court of Appeal found in the taxpayer’s favour, three nil.²⁸ HMRC appealed to the House of Lords.²⁹

C. The House of Lords

The House of Lords dismissed HMRC’s appeal, five nil. But this does not reveal that HMRC won half of the case (likewise five nil), but lost the other. The House of Lords held that the arrangement was clearly a settlement, but also that the gift of a share to Mrs Jones was not a gift of income.

All five judges gave reasoned opinions, the main ones being delivered by Lord Hoffmann and Lord Neuberger (each a Chancery practitioner while at the Bar).

Lord Hoffmann indicated his decision on the issue of whether there was a settlement already in paragraph 5 of his opinion: there he says that, ‘it was contemplated from the

²⁴ *Crossland (Inspector of Taxes) v. Hawkins* [1961] Ch. 537, and *Mills v. Inland Revenue Commissioners* [1975] A.C. 38.

²⁵ See in particular Park J.’s rehearsal of the Revenue’s line of argument: [2005] S.T.C. 1667, at 1702 f.

²⁶ See [2005] S.T.C. 1667, at 1673. This proved quite controversial in itself: see, for example, per Park, J., [2005] S.T.C. 1667, at 1699, and per Sir Andrew Morritt, C., [2006] 1 W.L.R. 1123, at 1149.

²⁷ Reported at [2005] S.T.C. 1667.

²⁸ Reported at [2006] 1 W.L.R. 1123.

²⁹ For a fuller discussion of the decisions of the lower courts, see Philip Simpson, ‘You, me and HMRC’, available at <http://www.murraystable.com/files/articles/You%20me%20and%20HMRC.pdf>.

outset that the company would pay Mr and Mrs Jones low salaries and distribute the rest of its income as dividends'. Having then translated the traditional term 'element of bounty' into the more prosaic 'benefit which not have been provided in a transaction at arm's length',³⁰ Lord Hoffmann held that the absence of a binding contract of employment between Mr Jones and the company did not mean that there was no settlement. An expectation could be part of an arrangement. There was a difference between the arrangement itself and the way in which, as foreseen, income arose under the arrangement.³¹ So the fact that Mr Jones, although not obliged to, went out into the world and earned money for the company, and the fact that, from year to year, Mr Jones made decisions about how much should be paid to him and to Mrs Jones by way of salary and what dividend should be declared, were not part of the arrangement: there were merely how income arose under the arrangement. So HMRC won on the first issue.

But on the second issue, HMRC lost, on all three of the grounds they put forward.³² According to Lord Hoffmann, the argument that there was no gift, because Mrs Jones had bought her share from company formation agents, failed as inconsistent with the point that the 'element of bounty' derived from Mr Jones' agreement that Mrs Jones should own half the company. The distinction Lord Hoffmann drew between the arrangement and the means by which income arose under it overcame HMRC's second argument, namely that the arrangement comprised more than just the share. But most importantly for practitioners, HMRC's claim that what had been gifted was in any event 'wholly or substantially a right to income' was held to be incorrect. The reason given by Lord Hoffmann is that the share was an ordinary share.

³⁰ At 2033.

³¹ See also Lord Walker of Gestingthorpe, at 2043.

³² At 2037 f.

This latter point was emphasised by Lord Hope of Craighead,³³ who went so far as to say that it did not make any difference that the company had in fact no assets when the arrangement was entered into.³⁴ HMRC's point in that respect was that it was unrealistic to regard Mrs Jones' share as including a right to surplus capital, given that the nature of the company's business made it unlikely that there would ever be any. The House of Lords' response was that one had to look at the objective characteristics of what was given; in any event, the company could, for example, expand by taking on employees at some stage.

Lord Walker of Gestingthorpe added some observations of his own. In particular, he reiterated that an intention to avoid tax is not a necessary element of a settlement,³⁵ and agreed that in identifying the component parts of a settlement, the key concept was 'sufficient unity'.³⁶

Lord Neuberger of Abbotsbury, giving the second main judgment, albeit last in the report, held that although one should assess whether an arrangement exists by reference to the time at which the arrangement is alleged to have been made, one ought not to disregard what happened thereafter.³⁷ It cannot be said that this is entirely clear; perhaps all that is meant is that in assessing whether an expectation of the type that can indicate an element of bounty actually existed, one can look to see whether bounty was in fact

³³ At 2038 f.

³⁴ At 2040. Equally, a company such as Arctic Systems could probably be expected never to have significant assets, so to regard the right to share in those assets as a substantial one might be thought to be 'divorced from reality'. On that basis, there is a fine distinction between the House of Lords' answers to the two issues raised.

³⁵ See *Inland Revenue Commissioners v. Plummer* [1980] A.C. 896.

³⁶ Relying on *Crossland (Inspector of Taxes) v. Hawkins* [1961] Ch. 537. The idea of 'unity' had previously been mentioned in *Commissioners of Inland Revenue v. Morton* 1941 S.C. 467.

³⁷ At 2049.

given and received. If it was, it is more likely that the intention existed from the start.³⁸

The absence of a binding contract of employment did not mean that there was no settlement: the expectation, in the event realised, that Mr Jones would work for the company at a reduced level of salary was sufficient. This meant that on Mrs Jones' acquisition of half the shares in the company, they were worth rather more than the par value she paid, even though this value depended on her personal relationship with her husband, and on her husband's continuing to own the other share. So her payment of par value was payment at undervalue.

Equally, it is difficult to see how one might go about valuing Mrs Jones' share on this basis. Notwithstanding the expectations that Mr Jones would work for the company and that at least some of the profits would be paid out by way of dividend, whether any money was earned was not entirely within Mr Jones' control. He might have been no good. His particular skill might have become obsolete. He might have fallen ill. And as a matter of fact, it would appear that Mrs Jones was not prepared to pay more than par value for the share.

On the issue of whether the settlement was an outright gift, not being of a right to income, Lord Neuberger held that the fact that Mrs Jones paid par value for her share did not mean there was no gift: a transfer at undervalue included an element of gift. The fact that there was more to the settlement than the transfer of the share did not win the case for HMRC either: the bounty in the settlement was the purchase at what, having regard to the parties' expectations as to what would happen in the future, was an undervalue.

³⁸ This echoes the idea expressed by Viscount Dilhorne in *Plummer*, namely that, 'The question to be decided is whether Parliament can have intended that the arrangement of which *the* main object was the obtaining of tax advantages should be outside the operation of [the predecessor to section 660G]. In my opinion the answer is in the negative...'

Finally, ordinary shares carried more than merely a right to income: even if in practice the most important feature of a particular share was an expectation of dividends, one had to look at the objective characteristics of the share.³⁹

So victory for Mr Jones.

IV. The Government's response

The Government has responded to the House of Lords decision by ministerial statement, the day after the decision was given, and some guidance published a few days later.⁴⁰

This suggests that the Government was at least ready to lose (although it may of course have had another statement ready in case it succeeded). The Government gave some information as regards both existing cases and its legislative intention.

First, the guidance states that all existing cases that HMRC have kept open will be reviewed, and HMRC will seek to settle them in line with the House of Lords' decision. In particular, this is acknowledged by HMRC to mean that where ordinary shares are involved, and whether in a company or in a partnership, the case will be within the exemption for outright gifts between spouses.⁴¹ Equally, although left unexpressed in the guidance, this presumably also means that where the shares involved are preference shares, it will be difficult to persuade HMRC that the settlements legislation does not apply.

Second, HMRC state that as regards self-assessment returns for 2005 / 2006, it 'explained in guidance at the time that these 2005 / 2006 returns should be completed in line with the Court of Appeal decision, which was in favour of Mr Jones, and suggested that the

³⁹ At 2052 f.

⁴⁰ Both are available at <http://www.hmrc.gov.uk/practitioners/sba.htm>.

⁴¹ Although, of course, there is a caveat in case of 'additional factors'.

blank space in the return form could be used by the taxpayer to say that they had done this.’ In fact, this is not quite what HMRC said at the time: what it said was:

‘The Court of Appeal judgement represents the law as it now stands. It follows therefore that taxpayers whose circumstances are consistent with the situation in *Jones v Garnett* are entitled to self assess or, within the time limits allowed, amend a self assessment in accordance with that judgement. Clearly, each individual case is different and it is not easy to lay down a clear line which defines whether a case is consistent with *Jones v Garnett*. To that extent taxpayers will need to be guided by their advisers. *If providing details using the ‘white space’ in a return is considered appropriate* it would be helpful if the entry could be made at box 7.32 on the “Trusts etc” pages of the individual SA return.’⁴² (Emphasis added.)

In any event, HMRC now states that returns filled in on this basis will not need to be amended.⁴³ This is not true. For example, a case identical to Arctic Systems save for the use of ‘*Young v. Pearce*’ preference shares instead of ordinary shares would, on the basis of the Court of Appeal decision, not have attracted the application of the settlements legislation, but would on the basis of the House of Lords’ decision. So a little more digging has to be done in individual cases than HMRC’s guidance suggests.

Third point on existing situations: the guidance states that new, more detailed guidance will be provided in autumn 2007, presumably replacing the document ‘A Guide to the Settlements Legislation for Small Business Advisers’.⁴⁴ However, this has not yet been published, and no further information has been made forthcoming as to when we might see it. But it is HMRC’s expressed intention to publish it ‘in good time for people to be able [to] prepare the 2006 / 2007 returns’.⁴⁵ So it will presumably be out reasonably soon. But what the guidance does not say is anything about error or mistake claims. These can be made up to five years after 31st January following the end of the relevant tax year (in

⁴² Available at <http://www.hmrc.gov.uk/trusts/jonesvgarnett-further-advice.htm>.

⁴³ See <http://www.hmrc.gov.uk/practitioners/sba.htm>.

⁴⁴ Available at http://www.hmrc.gov.uk/practitioners/guide_sba.pdf.

⁴⁵ Available at <http://www.hmrc.gov.uk/trusts/jonesvgarnett-further-advice.htm>.

other words, five years after the time limit for filing expires).⁴⁶ The absence of such a reference suggests that HMRC, probably correctly, is of the view that there was no ‘practice generally prevailing’ in favour of the application of the settlements legislation in circumstances in which the House of Lords has now said it does not apply. Accordingly, that bar on error or mistake claims will not prevent such a claim being made now. Of course, this does not help those who simply did not set up a *Jones v. Garnett* style structure, perhaps following the decisions of the Special Commissioners or of Park, J., in the High Court, on the basis that such structures would not succeed, or were too much trouble. It may be worthwhile reviewing the position of such clients now.

The second aspect of the Government’s response is its intentions as regards legislative change. In her opinion, Baroness Hale of Richmond identifies four broad categories of husband and wife companies. These are:

- (i) the spouses may expect that each will make a contribution to the company’s earnings of roughly equal financial value;
- (ii) they may expect that each will make a contribution which is equal in terms of effort but unequal in terms of earnings for the company;
- (iii) they may expect that each will contribute what they can but that those contributions will vary over time, perhaps because of personal factors such as illness or child rearing, perhaps because of changes in the business and its market; or
- (iv) they may expect that one will contribute the work which brings in the money from outside while the other will contribute the limited but necessary ancillary services to make that work possible but bring in no independent money from outside.⁴⁷

⁴⁶ Taxes Management Act 1970, section 33.

⁴⁷ At 2046 f.

It appears that HMRC expressly eschewed the idea of catching, by the settlement provisions, any of the four categories except the last.⁴⁸ *Jones v. Garnett*, of course, fell into the last category. But as mentioned above, the day after the House of Lords handed down its decision the Government put out a ministerial statement, as follows:

“The Government acknowledges the judgement given by the House of Lords in the *Jones v Garnett* (Arctic Systems) case.

The Government is committed to maintaining fairness in the tax system. The case has brought to light the need for the Government to ensure that there is greater clarity in the law regarding its position on the tax treatment of ‘income splitting’.

Some individuals use non commercial arrangements (arrangements that they would not reasonably enter into with an arms-length third party) to divert income (which would, in the absence of those arrangements have flowed to them) to others. That minimises their tax liability, and results in an unfair outcome, increasing the tax burden on other tax payers and putting businesses that compete with these individuals at a competitive disadvantage.

It is the Government’s 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 proposals for changes to legislation to ensure this is the case. In the meantime, HMRC will apply the law as elucidated by the House of Lords and will be providing guidance in due course.

The Government would not want commercial arrangements to be caught by any change to legislation. Consultation should help to ensure this.”

This appears to notify an attack on a much broader basis than what was said to Baroness Hale of Richmond. Specifically, it appears aimed at any transactions that would not have been entered into with an arm’s length party. This would suggest that not only category (iv) in Baroness Hale’s list but also categories (ii) and (iii) are a target for the legislation on which the Government will be consulting.

⁴⁸ Per Baroness Hale of Richmond, at 2047.

The risk is fairly clear: that the process does not involve true consultation, and results in badly drafted legislation which creates more uncertainty than there ever was in the first place. (It should be mentioned that the ministerial statement has been fairly severely criticised for suggesting there to have been a lack of ‘clarity’ in the existing law.⁴⁹ But given the widely differing views of the various judges (ten in all) who have heard this case, lack of clarity appears to be a valid criticism.)

On the one hand, one can sympathise with the view that the fact that a person is married should not allow him to obtain a reduction in his income tax bill. For example, if one spouse chooses not to work in order to stay at home to raise children, it is legitimate to argue that any State financial support should be by means of child benefit or child tax credit. If the choice is on the ground that the working spouse earns enough for both of them, it is not for the State to assist by making that money more than enough. An unmarried couple, and indeed a single person, should not be penalised by the tax system on account of their civil status. And if a married person is enabled to offer services for less money because he can reduce his tax liability by passing some of his income to his spouse in circumstances where his unmarried competitors cannot, this does distort competition. So even apart from the consideration, which is of course the primary, albeit unsaid, one in the Government’s mind, that the present legislation allows people to pay less tax than they otherwise might, there are reasons for limiting the possibility of transferring income between spouses.

In any event, despite announcing that it will consult, the Government seems to have made up its mind on the policy point already: non-commercial structures should not receive any tax advantages.

⁴⁹ See, in particular, Francesca Lagerberg, *Arctic Chill*, (2007) 160 *Taxation* 149.

The result of these considerations is that the consultation process is likely to focus on ensuring that any legislation is clear and workable in practice. This is the theme running through contributions by various commentators on the Government's response.⁵⁰ But how this will be achieved, particularly having regard to recent Finance Acts, is at the moment obscure.

IV. Practical matters

First, it may be mentioned that the present legislation is basically the same as that which was discussed in *Jones v. Garnett*. Thus the (relatively) new Income Tax (Trading and Other Income) Act 2005 ('ITTOIA') provides in section 620:

'(1) In this Chapter—

“settlement” includes any disposition, trust, covenant, agreement, arrangement or transfer of assets (except that it does not include a charitable loan arrangement),⁵¹ and

“settlor”, in relation to a settlement, means any person by whom the settlement was made.’

Section 624 of ITTOIA provides:

'(1) Income which arises under a settlement is treated for income tax purposes as the income of the settlor and of the settlor alone if it arises—

(a) during the life of the settlor, and

(b) from property in which the settlor has an interest.’

Section 625 provides:

⁵⁰ See, for example, *A chill wind*, (2007) 160 Taxation, 123; Francesca Lagerberg, *Arctic Chill*, (2007) 160 Taxation 149, and *Arctic Full Circle?*, (2007) Tax Adviser (September) 14; and the comments by the Chartered Institute of Taxation, available at <http://www.tax.org.uk/attach.pl/5088/6590/CTA%20News%20Sept07%20web.pdf> and <http://www.tax.org.uk/showarticle.pl?id=5786>.

⁵¹ A 'charitable loan arrangement' is 'any arrangement so far as it consists of a loan of money made by an individual to a charity either (a) for no consideration, or (b) for a consideration which consists of only interest': section 620(5) of ITTOIA.

- ‘(1) A settlor is treated for the purposes of section 624 as having an interest in property if there are any circumstances in which the property or any related property—
- (a) is payable to the settlor or the settlor’s spouse,
 - (b) is applicable for the benefit of the settlor or the settlor’s spouse, or
 - (c) will, or may, become so payable or applicable.’

Finally, section 626 provides:

- ‘(1) The rule in section 624(1) does not apply in respect of an outright gift—
- (a) of property from which income arises,
 - (b) made by one spouse to the other, and
 - (c) meeting conditions A and B.
- (2) Condition A is that the gift carries a right to the whole of the income.
- (3) Condition B is that the property is not wholly or substantially a right to income.
- (4) A gift is not an outright gift for the purposes of this section if—
- (a) it is subject to conditions, or
 - (b) there are any circumstances in which the property, or any related property—
 - (i) is payable to the giver,
 - (ii) is applicable for the benefit of the giver, or
 - (iii) will, or may become, so payable or applicable.’

Clearly, the best thing to do at the moment when setting up companies in similar situations to Arctic Systems is to make sure that the element of bounty comes in the form

of ordinary shares on which there are no restrictions in terms of entitlement to surplus capital on a winding-up or attendance and voting at meetings.⁵² Equally, even preference shares could be designed so as not to be ‘wholly or substantially a right to income’, by having full rights to share in capital and to attend and vote at meetings.⁵³

As regards existing companies, a review of their situation might indicate that, for example, their Articles of Association should be changed so as to make it more likely that they obtain the benefit of the judgment. Preference shares could be transformed into ordinary shares.

Finally, as regards tax returns already submitted, as mentioned above these should be reviewed where the settlements legislation has been considered. It may be that an error or mistake claim could be made where a self-assessment return has wrongly conceded the settlements legislation to be applicable. But it may also be that the self-assessment return has wrongly proceeded on the footing that the legislation was inapplicable. If so, this year’s return is likely to be on a different footing, and this may well be noticed by HMRC. Given the new civil penalty regime,⁵⁴ it is worthwhile considering in this situation whether to notify HMRC of the error in past returns.

V. Conclusion

In conclusion, the case itself is far from the end of the story. Its effects must now be worked out, and appropriate steps taken, in relation to existing situations and to returns already submitted. We must also be astute to respond to the expected consultation

⁵² See in particular per Lord Hope of Craighead, at 2039.

⁵³ This is hinted at by Lord Walker of Gestingthorpe, at 2044. Of course, why one would want to issue preference shares with such rights is a separate question.

⁵⁴ See Finance Act 2007, section 97 and Schedule 24, in particular paragraph 9.

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document, and, even if unable to persuade the Government to change its mind on the policy issue, seek to ensure that any eventual legislation is clear and workable.