

USEFUL EVENTS
GLASGOW, 13th November 2006; EDINBURGH, 20th November 2006

You, me and HMRC

by

Philip Simpson

**Advocate ~ Barrister
Chartered Tax Adviser**

I. Introduction

At the end of his judgment in the case of *Jones v. Garnett*¹ 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.’² Having come 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.’³ 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. So the judgment of the House of Lords is awaited on this ‘simple application of well-established principles’. But the difficulties in this area make it likely that as many problems will be created as will be solved, no matter what their Lordships say. Absent the political will for more fundamental reform of the tax system,⁴ it may take a good deal of litigation to achieve some clarity.

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

² [2005] S.T.C. 1667, at 1711.

³ [2006] 1 W.L.R. 1123, at 1151.

⁴ 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 / 2000.⁵

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 income 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 wife⁶ 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.'

⁵ The provisions have since been replaced by sections 620 ff. of the Income Tax (Trading and Other Income) Act 2005: see below.

⁶ This does not apply if settlor and beneficiary are merely living together.

USPUL EVENTS

GLASGOW, 13th November 2006; EDINBURGH, 20th November 2006

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.⁷ 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.'⁸

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.⁹ 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

⁷ See [2005] S.T.C. 1666, at 1687, paragraph 102.

⁸ 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.

⁹ *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,¹⁰ 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.¹¹ Having held that they could not achieve this aim by restricting the meaning of the types of transactions identified,¹² or by reading in an exception for *bona fide* commercial transactions,¹³ they have elected for the criterion of 'bounty'.¹⁴ The meaning of this criterion in turn was one of the main issues raised in the case that forms the subject of this paper.

¹⁰ 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.

¹¹ See in particular *Inland Revenue Commissioners v. Plummer* [1980] A.C. 896, at 911 per Lord Wilberforce, and at 923, per Lord Diplock.

¹² 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.

¹³ First floated in *Copeman v. Coleman, for Coleman Minors* [1939] 2 K.B. 484.

¹⁴ 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,¹⁵ at least since independent taxation of spouses was introduced in 1988,¹⁶ and certainly following the introduction of the 0% starting rate of corporation tax in 2000¹⁷ (now abolished¹⁸).

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 the 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.

¹⁵ 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'.

¹⁶ 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.

¹⁷ By Finance Act 1999, section 28, inserting section 13AA into ICTA 88.

¹⁸ Finance Act 2006, section 26.

USEFUL EVENTS

GLASGOW, 13th November 2006; EDINBURGH, 20th November 2006

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.¹⁹

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. 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.

It is clear that the diversion of employment income could constitute the provision of funds into a settlement.²⁰ 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,

¹⁹ See in particular [2005] S.T.C. 1667, at 1689.

²⁰ *Crossland (Inspector of Taxes) v. Hawkins* [1961] Ch. 537, and *Mills v. Inland Revenue Commissioners* [1975] A.C. 38.

whether the exception for an outright gift to a spouse not consisting wholly or substantially in a right to income applied.²¹

B. The Special Commissioners

Two Special Commissioners heard the case at first instance. They being split on the matter, the chairwoman got the casting vote. She cast it in favour of HMRC.²²

As regards the question of a 'settlement', the chairwoman held that the crucial issues in determining whether something was an 'arrangement' that constituted a settlement were first, whether 'what was done, in whole or in part, was a definite scheme to bring about a desired result' and second, whether there was an element of 'bounty'.

Taken together, the purchase of the company by Mr and Mrs Jones, the provision of Mr Jones' services through the company, the payment of modest salaries and the declaration of dividends constituted such a scheme. The desired result was that part of the profits should be paid to Mrs Jones by way of dividend, and therefore taxed at a lower rate than they otherwise might be. It was not necessary that all of the elements constituting the settlement occur at the same time, or even that they all be contemplated from the outset, provided there was sufficient unity about them.²³

As regards the question of bounty, the issue boiled down to whether Mr Jones was worse off having made the arrangement. The chairwoman found that he was, by having allowed his wife to acquire a 50% shareholding, even though she paid full value for it, and by thereafter not drawing a market salary and instead declaring a dividend, overall with the result that money that should have gone to Mr Jones went instead to his wife. This

²¹ See in particular Park J.'s rehearsal of the Revenue's line of argument: [2005] S.T.C. 1667, at 1702 f.

²² 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.

²³ Relying on *Crossland (Inspector of Taxes) v. Hawkins* (cited above, note 20). The idea of 'unity' had previously been mentioned in *Commissioners of Inland Revenue v. Morton* (cited above, note 12).

USEFUL EVENTS

GLASGOW, 13th November 2006; EDINBURGH, 20th November 2006

requirement was satisfied even though some of the steps in the arrangement were standard commercial steps, for instance the acquisition of a company.

The chairwoman then turned to the second issue, namely whether there was an outright gift by Mr to Mrs Jones, not consisting wholly or substantially in a right to income. She held that in practice the only right conferred by the share Mrs Jones held was a right to dividends. Whether any dividends were paid depended entirely on whether Mr Jones decided to declare any. So the gift involved in the settlement was indeed substantially a right to income. The exception did not apply.

The other Special Commissioner took the view that to determine whether the arrangement constituted a 'settlement' for the purposes of ICTA 88, one had to make a judgment as of the time Mrs Jones acquired her share in the company. The essential elements of a settlement were that it should include the property that produced the income to be transferred back to the settlor, and should involve an element of bounty.

The Special Commissioner held that the 'settlement' was merely the 'arrangement' that the shares should be owned equally by the spouses, that Mr Jones would be appointed sole director, and that it was expected that both would work for the company, Mr Jones at least drawing a low salary, and that if there were distributable profits dividends would be paid. Although the fact that, in the event, Mr Jones drew a salary below market rates constituted bounty, that bounty arose only when he determined his salary: it was not present at the time the settlement was made. At that time, Mr Jones merely intended to provide bounty at some point in the future, but that intention did not make him any worse

USEFUL EVENTS

GLASGOW, 13th November 2006; EDINBURGH, 20th November 2006

off. He could have changed his mind at any time, and indeed did so in relation to a couple of years when he drew full salary.²⁴

In any event, even if there had been an element of bounty present, the bounty was the amount by which the value of the share Mrs Jones acquired exceeded the price she paid for it (in other words, par value), taking into account the facts that Mr Jones might draw less than full salary and any shortfall would benefit the shareholders. This was an outright gift by Mr Jones, and not wholly or substantially of a right to income. Accordingly, it was excepted anyway from the settlements legislation.

Given the casting vote of the first Special Commissioner, Mr Jones lost at first instance. He appealed to the High Court of Justice.

C. *The High Court of Justice*

The appeal was heard by Mr Justice Park. He agreed with the Revenue and dismissed the appeal.

The first question he considered was whether the structure was an 'arrangement' constituting a 'settlement'. For him too, this depended on bounty. His view was that the fact that there was no more than an intention that the structure could be used as a means of providing bounty at a future date did not prevent it from being a 'settlement'. The word 'arrangement' suggested that not only the transactions at the time but also the reason for those transactions should be taken into account.²⁵ The point of having one

²⁴ It may be noted that this case occurred in England, and that one of the points made by the Special Commissioner was that, 'A promise to give is not binding and does not make the person giving it worse off as a result.' Obviously, this is not the case in Scotland. But had the facts occurred here, any promise along the lines of Mr Jones' intention would clearly have been unenforceable on account of uncertainty in any event.

²⁵ 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...'

USEFUL EVENTS

GLASGOW, 13th November 2006; EDINBURGH, 20th November 2006

share acquired by Mrs Jones was that she would be able to receive dividends in the future, and it was clear that those dividends would come to her as bounty. The fact that the word 'agreement' also appeared in the definition of 'settlement' suggested that something that was not legally binding could none the less be an 'arrangement'. The intention even just that the structure should be available to be used as a means of Mr Jones providing bounty to Mrs Jones was sufficient to bring it within the scope of the settlements legislation.²⁶

As regards the question whether the arrangement fell within the spouse exception, Park, J., held that it did not. The reason was that no part of the arrangement could be said to involve an 'outright gift'. In particular, Mrs Jones purchased her share. In any event, the exception was aimed at gifts of income-yielding property by one spouse to another.

Park, J., seems to be meaning that for the exception to apply the gift element must relate to the capital value of the income-producing property, and not to the income subsequently arising to it. It may be mentioned that this is entirely consistent with Park, J.'s view of the first question. Mrs Jones purchased her share for what was probably its market value at the time. The company had no assets other than the £2 subscribed. Mr Jones was under no obligation to work for it. Given that he was the sole director, even if he did work for it there was no obligation on him to accept a reduced salary. So the element of bounty actually occurred when a low salary was paid and a high dividend declared.

Accordingly, it was unnecessary to answer the question whether any gift was wholly or substantially of a right to income. But, *obiter*, Park, J., agreed with the Presiding Special Commissioner on that point.

²⁶ [2005] S.T.C. 1667, at 1708.

Accordingly, the appeal was dismissed. Mr Jones then tried his luck in the Court of Appeal.

D. The Court of Appeal

In the Court of Appeal, the case was heard by Sir Andrew Morritt, C., and Keene and Carnwath, L.JJ.

By this time, submissions were focussed on what transactions could be considered together for the purpose of determining whether there was an arrangement.

Sir Andrew Morritt gave the leading judgment. For him too, the first issue came down to whether there was any element of bounty in the corporate structure. To determine that, one had to identify what the alleged arrangement was. In his view, the arrangement comprised first and foremost the acquisition by Mrs Jones of her share; but this was for full value in the context of a joint business venture to which both parties were to make substantial and valuable contributions. It included also the corporate set-up whereby Mr Jones was sole director and held the other share, and accordingly controlled the company at board and shareholder level. A key point in the judgment of Sir Andrew Morritt is that this did not of itself confer bounty, but merely made it possible for Mr Jones to confer bounty in the future. His Lordship then identified the bounty that the Revenue relied on, namely the combination of the demand and charge-out rates for Mr Jones, the salary in fact paid to him, the company's other commitments and the dividend declared and paid to Mrs Jones. It was pointed out that all these depended on Mr Jones' free will, or on wholly extraneous factors, such as market conditions for I.T. services. The uncertainty that all

these things combined to create meant that there was nothing 'definite' about the arrangement.²⁷ Accordingly, there was no settlement.

Sir Andrew Morritt, C., considered *obiter* the issue of the exception for outright gifts to spouses. On the assumption that there in fact was an arrangement, then Park, J., had been correct in both reasoning and result as to whether there had been an outright gift: there had not. But if there had, then contrary to what the Presiding Special Commissioner and Park, J., held, the gift was not wholly or substantially a right to income. This was because an ordinary share involved not only a right to income but also a right to participate in assets if the company were wound up, and to vote at general meetings. This was not affected by the arrangement.

The other two judges concurred, but each also gave a short judgment.

Keene, L.J., emphasised that 'those matters which constitute the arrangement and hence the settlement must be identifiable by a particular point in time, as opposed to there being something which may or may not turn out to be a settlement if certain future events happen'.²⁸ An expectation could not be included as part of an arrangement if it was as to matters too speculative and uncertain. There was not even any specific amount of salary that, it was expected, Mr and Mrs Jones would draw. Likewise, the anticipated bounty was too uncertain and speculative as of the date of the alleged settlement.

Carnwath, L.J., went rather further. Having pointed out that the idea of 'bounty' was a judicial gloss on statutory words and that its nature as such made the exercise of interpreting it more difficult, he stated his view that the Revenue's position in the case

²⁷ The requirement that there be a 'definite scheme' had been indicated in *Commissioners of Inland Revenue v. Payne* (1940) 23 T.C. 610, at 626 per Sir Wilfred Greene, M.R. Contrast the view of the presiding Special Commissioner: [2005] S.T.C. 1667, at 1677.

²⁸ [2006] 1 W.L.R. 1123, at 1150.

USP/H. EVENTS

GLASGOW, 13th November 2006; EDINBURGH, 20th November 2006

was a significant extension of the settlements legislation. It had not previously sought to apply it to a normal commercial transaction between two adults,²⁹ each of whom made a substantial commercial contribution, albeit those contributions were not of the same economic value. But the difference between the economic values of the respective contributions was ‘not enough ... to take the arrangement into the realm of “bounty”’. So there was no bounty at all – a position that had not even been argued, counsel for Mr Jones having accepted that payment to Mrs Jones of an overall return that was not justified by her economic contribution constituted ‘bounty’ within the meaning of the existing jurisprudence.³⁰ The basic idea is that where the economic value of the contribution made by the benefited spouse is more than *de minimis*, or is not merely a sham, then there is no bounty.

E. Appeal to the House of Lords

The Court of Appeal, somewhat surprisingly, refused permission to appeal to the House of Lords; but the House itself granted it. The petition was presented on 20th April 2006, but as of today it has not been set down for a hearing. So the hearing itself is not going to be this year; and there will of course be some time between the hearing and the speeches. I think the House of Lords will follow the Court of Appeal. In particular, the requirement of bounty was set up by the House of Lords in *Plummer* by reference to what the House regarded as Parliament’s intention, namely to tax in the hands of the settlor income that he ‘gives away’.³¹ This suggests that it is only once there is some certainty that income

²⁹ The fact that a transaction was fairly ‘normal’ was mentioned also in *Plummer* (cited above, note 11), per Lord Wilberforce at 907.

³⁰ This may be contrasted with Lord Diplock’s view in *Plummer* (cited above, note 11), that even where the amount in effect received by the charity was only about 60% more than the amount it paid to the taxpayer there was a substantial element of ‘bounty’, notwithstanding that the taxpayer’s payment to the charity was out of pre-tax income, and, post-tax, was almost exactly what the charity paid him.

³¹ *Plummer* (cited above, note 11), at 912 per Lord Wilberforce.

USEFUL EVENTS

GLASGOW, 13th November 2006; EDINBURGH, 20th November 2006

has been or will be given away that there can be a settlement. The fact that an arrangement is put in place that will be available to be used as a mechanism for giving income away cannot be enough: otherwise, the mere possibility that income will be given away allows an arrangement to be regarded as a 'settlement' for the purposes of the legislation, whether or not there is in fact an intention that it should be used for that purpose, and more or less anything might be a settlement.

The view of Park, J., that one must regard the reason for the arrangement as being part of the arrangement itself is in substance the same as restricting the meaning of the term 'settlement' by reference to the criterion of whether the purpose of it is tax avoidance. This view was rejected by the House of Lords in *Plummer*.³² It is too late now to resurrect it. The House of Lords has moreover made clear that it is unnecessary for there to be any mental element present in the settlor in order for an arrangement to be a settlement.³³ If the absence of a mental element cannot count in the taxpayer's favour, the presence of a mental element ought not to count against him. The sole issue is 'bounty', and this is an objective criterion.

In any event, I do not think it is legitimate to separate out the different elements of the arrangement, as Park, J., did by slicing off Mrs Jones' work for the company on the one hand and the remuneration the company paid to her for it on the other. In this way the disparity between contribution put in and reward taken out greatly increased. Instead, as has been clear from at least 1940, 'the whole of what was done must be looked at'.³⁴ This

³² In particular, this was the ground on which Viscount Dilhorne and Lord Diplock dissented: [1980] A.C. 896, at 920 and 924 respectively; and it was clearly rejected by the majority of the committee: see in particular per Lord Wilberforce at 913, who regarded such an approach as unworkable.

³³ *Mills v. Inland Revenue Commissioners* (cited above, note 20), in particular at 51 ff. per Viscount Dilhorne.

³⁴ *Commissioners of Inland Revenue v. Payne* (cite above, note 27), at 626 per Sir Wilfred Greene, M.R. See also, for example, the judgment of Plowman, J., in *Commissioners of Inland Revenue v. Leiner* (1964)

USEFUL EVENTS

GLASGOW, 13th November 2006; EDINBURGH, 20th November 2006

is indeed what the Revenue advises.³⁵ Looked at as a whole, and even taking account of the low salary Mr Jones drew, the 'arrangement' is closer to being a normal, commercial structure.³⁶

The difference between this case and, for example, *Crossland v. Hawkins*³⁷ is that the service agreement between the taxpayer and the company was entered into as part of the arrangement, and the salary to be paid to him was so ridiculously low that it was inevitable that performance of his obligation to provide services to the company, by means of the company lending his services out to film production companies, would inevitably transfer his income to the shareholders in the company, whether by way of dividend, if declared, or capital appreciation.³⁸ But what was taken into account as forming part of the 'arrangement' in that case was limited to structure: transactions exploiting that structure did not form part of the 'arrangement'. This distinction between structure on the one hand and exploitation of structure on the other is implicit in the early case of *Commissioners of Inland Revenue v. Payne*.³⁹ In that case, a tax avoidance scheme consisted of the taxpayer obtaining control of a company and then covenanting to pay it annual amounts, these to be deducted from his taxable income as a charge. According to the Master of the Rolls, Sir Wilfred Greene, it was 'by placing himself into these relationships with the company [that] Mr Walter Payne was engaged in making an

41 T.C. 589, at 596: 'The transaction, *taken as a whole*, was not, in my judgment, one which, from the point of view of the Respondent, can be described as a commercial arrangement, because he was liable to pay £2,040 per annum without any compensating advantage to him.' (Emphasis added.) Finally, see also Lord Wilberforce, first in *Plummer* (cited above, note 11), at 907, and second, repeating that dictum in *Chinn v. Hochstrasser* [1981] A.C. 533, at 547.

³⁵ See paragraph 3.5 of the Revenue publication, 'A Guide to the Settlements Legislation for Small Business Advisers', available at http://www.hmrc.gov.uk/practitioners/guide_sba.pdf.

³⁶ For what it is worth, this is also supported by the more general trend to regard domestic support given by a lower earning spouse as equally important to the financial success of the couple taken together. This can be seen in particular in various expensive divorce cases on both sides of the Atlantic in the past few years.

³⁷ Cited above, note 20.

³⁸ See also *Young v. Pearce* [1996] S.T.C. 743, discussed below.

³⁹ Cited above, note 27.

“arrangement” within the meaning of the definition of ‘settlement’.⁴⁰ But he then still had to deal with the company so as to achieve his object.⁴¹ In *Jones v. Garnett*, the structure is the corporate structure, and there is no bounty inherent in it.

So for all these reasons I think that the House of Lords will refuse the Revenue’s appeal.

IV. Practical points

However, the decision of the House of Lords is some time away, and clients require to be advised before then. Three practical points may be mentioned.

The first is that there are only three months left for submitting tax returns for 2005 / 2006. The deadline is 31st January 2007.⁴² Given the division of opinion so far in *Arctic Systems*, it is not a straightforward thing for Mr and Mrs Jones to decide the basis on which they should fill in their tax returns, far less for the thousands of other taxpayers affected.⁴³

The legislation remains substantially the same, albeit in the (relatively) new Income Tax (Trading and Other Income) Act 2005 (‘ITTOIA’).

Section 620 of ITTOIA provides the definition of settlement:

‘(1) In this Chapter—

⁴⁰ (1940) 23 T.C. 610, at 626.

⁴¹ See also *Young v. Pearce* (cited above, note 38), at 748. In that case the Revenue argued that the annual declaration of dividends by the company constituted part of the ‘settlement’. The Special Commissioner said, ‘I do not understand how the dividends can be both an intrinsic part of the alleged settlement and the income of the settlement, as is alleged.’ Although the decision was reversed on appeal, by that time the settlement was alleged to consist only in the creation and allotment of the preference shares, and not to include the annual declaration and payment of dividends: [1996] S.T.C. 743, at 749.

⁴² Taxes Management Act 1970, section 8.

⁴³ The Revenue has estimated that 30,000 taxpayers are affected, but this figure is widely regarded as far too low. See, for example, Mike Trueman, *Arctic Killer?*, [2005] Taxation 149, at page 152. Counsel for Mr Jones stated to the High Court that 200,000 families would be affected by the decision. See G. Loutzenhiser, *High Court gives taxpayer the cold shoulder* [2005] B.T.R. 401, at 410.

USEFUL EVENTS

GLASGOW, 13th November 2006; EDINBURGH, 20th November 2006

“settlement” includes any disposition, trust, covenant, agreement, arrangement or transfer of assets (except that it does not include a charitable loan arrangement),⁴⁴ 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:

- ‘(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.

⁴⁴ 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.

HUSBAND EVENTS

GLASGOW, 13th November 2006; EDINBURGH, 20th November 2006

- (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.’

As mentioned above, the House of Lords has yet to hear the case, and indeed its judgment may not be issued in time even for 31st January 2008. So the present uncertainty is of serious concern.⁴⁵ The basic question is what should taxpayers put in their tax returns? The Revenue has not been particularly helpful in its advice.⁴⁶ A robust approach may result in penalty interest being payable. Erring on the side of caution will give the taxpayer room for manoeuvre until the following 31st January: a self-assessed return may be amended until 12 months after the filing date.⁴⁷ But thereafter, whether an appeal may be made on the ground of error or mistake will depend on whether it can be said that what the taxpayer did was simply in accordance with prevailing practice at the time.⁴⁸ Certainly, it is necessary to examine every case in detail, in the light of the basis of the Court of Appeal’s judgment. In cases of doubt, the best approach may be to declare in the

⁴⁵ For an indication as to how fact-sensitive the issue is, see for example Loutzenhiser, *Court of Appeal puts HMRC on ice* [2006] B.T.R. 140, at 143 f.

⁴⁶ See <http://www.hmrc.gov.uk/trusts/jonesvgarnett-further-advice.htm>. The advice is, in short, that taxpayers should seek advice from their tax advisors.

⁴⁷ Taxes Management Act 1970, section 9ZA.

⁴⁸ Taxes Management Act 1970, section 33A. Having said that, it is unlikely that there is any ‘prevailing’ practice in relation to husband and wife companies at the moment.

USEFUL EVENTS

GLASGOW, 13th November 2006; EDINBURGH, 20th November 2006

so-called 'white box' that sections 620 ff. of ITTOIA may apply in respect of income included in the other spouse's tax return. This at least puts a time limit of 12 months on the Revenue making any enquiry into the matter.⁴⁹

The second practical point is as to the advice that should be given to spouses who want to set up such companies just now. It is of course impractical to advise them simply to wait a year or so for the Judicial Committee's judgment. So what should they be advised to do?

It is fair to say that so far as the Court of Appeal was concerned, the crucial matter preventing future dividends being included in the 'arrangement' and consequently providing the necessary bounty was uncertainty. It is also fair to say that the only point of uncertainty that took this case beyond the previous case-law in which, despite the involvement of future events, a settlement was held to have existed was the absence of a service contract. Otherwise, in terms of certainty of result, the case was on all fours with *Crossland v. Hawkins* [1961] Ch. 537, in which the then settlements legislation was held to apply.⁵⁰ So the first point is that the arrangement should be kept vague, in particular as regards the salary that the working spouse is to be paid. But a warning is necessary. The uncertainty that always arises as to whether there will be any dividends declared is not enough to prevent there being an element of bounty.⁵¹ So this should not be relied on as

⁴⁹ Taxes Management Act 1970, section 9A(2) in conjunction with section 29.

⁵⁰ It should be mentioned that the report of that case is not clear as to whether Mr Hawkins had any input in declaring a dividend. On the one hand, he was the director of the company involved, Westmead Productions Limited, and had to agree to the dividend (see in particular [1971] Ch. 537, at 550 per Donovan, L.J., and at 553, per Holroyd Pearce, L.J.); on the other, it seems that Mr Hawkins was not entirely aware of what was being done on his behalf, leaving much to his lawyers and accountants (for example, [1971] Ch. 537, at 551 per Donovan, L.J., and at 553, per Holroyd Pearce, L.J.).

⁵¹ See, for example, *Young v. Pearce* (cited above, note 38), in particular per Sir John Vinelott at 755. This point in any event is presupposed by all the cases involving companies paying dividends, namely *Copeman v. Coleman* (cited above, note 13); *Mills* (cited above, note 20); *Hawkins* (cited above, note 20); and *Butler v. Wildin* [1989] S.T.C. 22.

USEFUL EVENTS

GLASGOW, 13th November 2006; EDINBURGH, 20th November 2006

enough to preclude the existence of a settlement. The second point is that given that the arrangements are to be looked at as a whole, if in any year the fee-earning spouse is paid a salary at below market rate, the non-fee-earning spouse should likewise be paid below market rate. This means that the disproportion caused by the payment of a dividend is reduced. Finally, the third point that should be made is that if one spouse is not going to contribute to the business at all, then the fee-earning spouse should simply set up the corporate structure initially as a sole shareholder and then give away a proportion of the ordinary shares to the other. This is likely to ensure that the exception applies.

The third practical issue is value. The element of bounty must be inextricably linked with the question of any value provided by the beneficiary⁵² of the settlement: according to the Revenue, 'bounty is the provision of value without any corresponding quid pro quo, usually a gift or a transfer at less than full value'.⁵³ The judgments are not entirely clear as to their approach to the value provided by Mrs Jones. She got paid properly for her administrative tasks. But as regards what she paid for her one share, it was said in the Court of Appeal that 'there can be no doubt that the acquisition on its own was for full value in the context of a joint business venture to which both parties made substantial and valuable contributions.'⁵⁴ There was no evidence that she paid less than what was its market value at the time. And as the second Special Commissioner said, 'If [Mr Jones] had provided bounty at the time that Mrs Jones acquired her share the logical conclusion

⁵² Using that term in a broader way than normal, to correspond to the broader statutory meaning of the word 'settlement'.

⁵³ A Guide to the Settlements Legislation for Small Business Advisers, paragraph 3.6.1.

⁵⁴ Per Sir Andrew Morritt, C.: [2006] 1 W.L.R. 1123, at 1145. See comment in Tax Journal, 30th May 2005, page 11.

USEFUL EVENTS

GLASGOW, 13th November 2006; EDINBURGH, 20th November 2006

would be that the shares had a value in excess of the price paid for them. It is difficult to see how there could be any other conclusion.⁵⁵

This leads to a practical planning point. I would suggest that when such an arrangement is set up, the shares to be issued to the lower-taxed spouse be independently valued. In *Jones v. Garnett*, given the uncertainties of the arrangement the valuation probably would have been £1 per share. It is unlikely that a third party would have paid more, for what was essentially a speculation on Mr Garnett electing in future years to take a low salary and declare large dividends.⁵⁶ But in a case such as *Young v. Pearce*, the valuation might make a real difference. In that case, the two shareholders in a company were also its directors. The company had been set up in 1977, and had generally been profitable as of the time of the arrangement, in 1990.⁵⁷ They resolved to create a new class of preference shares entitled by way of dividend to 30% of the company's pre-tax profits in any year in which a dividend were paid,⁵⁸ but carrying no right to vote at general meetings and no right to share in capital on winding up, save for the repayment of the amount subscribed. The shares were allotted at par (£1 each) to the shareholders' wives. But the shares must have had a market value, even taking into account that the company elected to pay no dividends or, which is much the same thing in terms of return on investment, did not make a profit. If the shares had been valued by an independent valuer and the two wives had paid market value for them, it would have been impossible for the Revenue to argue

⁵⁵ [2005] S.T.C. 1667, at 1692.

⁵⁶ In other words, giving away his income in the future. This emphasises that it was not until the decisions were made in each year that there could truly be said to be an element of bounty. Of course, in some circumstances the exercise will be highly artificial: Mr Jones would be far less likely to declare large dividends if the other shareholder were an unconnected third party than if it were his wife.

⁵⁷ By coincidence, immediately following the introduction of independent taxation of spouses.

⁵⁸ In the event, rather more than 30% of profits were paid to the preference shareholders each year, but this did not make any difference in the appeal: [1996] S.T.C. 743, at 747.

that there was any element of bounty.⁵⁹ If it can be shown that the lower taxed spouse put a reasonable amount of money at risk in relation to the potential rewards (taking into account the likelihood that those rewards would be distributed) the settlements legislation is much less likely to apply.⁶⁰

Of course, this strategy has its risk: a valuer may come back with a value that is too high to allow the lower earning spouse to subscribe for shares at that value. But in that event the answer is perhaps even easier, and as suggested above. The higher earning spouse must simply subscribe for or acquire all the ordinary⁶¹ shares and then give an appropriate number to the lower earning spouse. This will count as an outright gift, and will not be wholly or substantially of income. Accordingly, if to a spouse it will be excepted from the settlements legislation.⁶²

VI. Conclusions

Perhaps one of the key points to take out of this affair is not to do with the interpretation or application of the settlements legislation, but to do with the importance of certainty in tax law generally. Even Park, J., who held against Mr Jones, remarked that at the time Arctic Systems was set up, no-one contemplated that the settlements legislation might apply.⁶³ It seems fairly clear that not only Mr and Mrs Jones but also the tax advisory profession was taken rather by surprise by the Revenue's decision to apply the legislation to the Jones. Given the progress of the case so far through the courts, it is absolutely clear

⁵⁹ See also *Butler v. Wildin* (cited above, note 51), at 38.

⁶⁰ As regards the assumption of risk, see in particular *Butler v. Wildin* (cited above, note 51), at 36 per Vinelott, J.

⁶¹ They must be ordinary shares, and not preference shares: compare *Young v. Pearce* (cited above, note 38), with, in particular, the dictum of Sir Andrew Morritt in *Jones v. Garnett* (cited above, note 1), at 1149.

⁶² This solution would not have worked in *Young v. Pearce* (cited above, note 38), given the conclusion that the preference shares constituted in substance a right to income and nothing more than that.

⁶³ [2005] S.T.C. 1667, at 1708.

USEFUL EVENTS

GLASGOW, 13th November 2006; EDINBURGH, 20th November 2006

that thousands⁶⁴ of taxpayers are going to have serious difficulty in deciding how to fill out their tax returns, not only this year but probably next year too; and depending on exactly what the House of Lords says it may be only by more litigation that some certainty can once more be achieved.

Second, it was presumably the purpose of drawing the definition of settlement so widely to catch as many transactions as possible. But the courts have simply refused to take the draftsman at his word, and have introduced a condition entirely absent from the statutory words, namely 'bounty'. So the draftsman has not achieved his purpose. Moreover, by forcing the courts to read a new concept into the legislation, vast uncertainty has been created. For 'bounty' is nothing more than a judicial gloss, and has no fixed meaning. In particular, Lord Russell of Killowen has said that the courts must not interpret the term 'too rigidly'.⁶⁵ However, this approach is likely to lead to expansionary pressure on the concept, with the Revenue seeking to bring more and more cases within its scope.⁶⁶ Taxpayers may be in for a long fight with the Revenue. This can only be to the detriment of taxpayers and of the legitimacy of the UK tax system.

⁶⁴ For estimates, see above, note 43.

⁶⁵ *Chinn v. Hochstrasser* [1981] 1 A.C. 533, at 555. The full quote is: 'My Lords, I would venture to point out that the word "bounty" appears nowhere in the statute. It is not a word of definition. It is a judicial gloss upon the statute descriptive of those classes of case which are caught by the section in contrast to those which are not. The courts must, I think, be extremely careful not to interpret this descriptive word too rigidly.'

⁶⁶ See comment on Park, J.'s decision by G. Loutzenhiser, *High Court gives taxpayer the cold shoulder* [2005] B.T.R. 401, at 405, supporting the expansion of the concept.