# Business Tax Update

## WHAT'S MINE IS YOURS ...

The introduction of the 50% "supertax" from April 2010 for those earning over £150,000 is focussing the minds of many high-earning taxpayers on ways of mitigating this additional tax liability. For husbands and wives that own a business, a significant tax saving can be achieved by the careful structuring of the ownership of their business. This opportunity is examined in more detail below.

### Background

When Independent Taxation was introduced in 1989, Norman Lamont (then Chancellor) told the House of Commons that it was "*bound to mean that some couples will transfer assets between them with the result that their total tax bill will reduce*." He went on to say that "*this is an inevitable and acceptable consequence of taxing husbands and wives separately*".

Despite this clear indication that couples would be able to organise the tax affairs of their businesses to minimise their total tax liability, HMRC have spent a number of years, and not inconsiderable sums of money, arguing that they can ignore the actual business ownership arrangements couples have put in place, and instead tax them on the basis of a tax "fiction".

### Arctic Systems

The latest court case on this issue was Jones v Garnett in 2007, which is perhaps best known as "Arctic Systems". In summary, HMRC tried, and failed, to argue that dividends paid to Mrs Jones as a result of shares she owned in her husband's company should be taxed on Mr Jones because his technical expertise generated the company's profits.

After several years of litigation, the case reached the House of Lords. HMRC argued that since Mr Jones, the sole director and chairman, generated the company's profits but drew out a minimal salary, then under the "settlement provisions" dividends paid out on his wife's 50% shareholding should be assessed as his income. The couple would therefore be unable to utilise the wife's personal allowance and lower tax rate bands to reduce their overall tax liability.

The House of Lords readily agreed that there had been a "settlement" by Mr Jones as contended by HMRC - Mrs Jones had paid for her shares at par and these shares carried the right to receive dividends which she and her husband expected to be paid. However, the Law Lords noted that special rules for settlements between spouses disapply the settlement provisions for any outright gifts of assets which are not wholly (or substantially) the right simply to receive income.

The Law Lords determined that as Mrs Jones' shares were ordinary voting shares they carried rights not just to income, but other rights such as voting rights and the right to assets on a winding up. As a result, the special rules provided an escape from the settlement provisions, and the Law Lords ruled that the income was correctly taxable on Mrs Jones and not on Mr Jones.

It should be noted that had Mrs Jones held, say, non-voting preference shares then HMRC may well have won the argument as these shares would then have represented a right "wholly or substantially" to income.

Following on from this defeat, HMRC quickly announced they would be introducing legislation to prevent this type of "income-shifting", which they considered to be "unfair". However, once the draft legislation was issued it was roundly criticised as impractical. Since then, and perhaps in part because of a focus on more "pressing" matters, the issue has moved to the bottom of HMRC's "to do" pile.

It therefore seems that, for the present at least, it is acceptable for smaller businesses and companies to arrange their affairs to take advantage of the spouse's lower tax rates without triggering an attack under the settlement provisions, provided that the arrangements are correctly implemented.

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### 50% "Supertax"

With the introduction of the new 50% "super tax" from 6 April 2010 for those earning over £150,000, this type of planning is even more beneficial. This point can best be illustrated with examples comparing the position for husband and wife for the tax year 2010/11, assuming that:

- The wife has no other income;
- The husband is liable to tax at 50% (ie he has other income of at least £150,000); and
- The tax rate band thresholds are as for 2009/10.

| Tax Year 2010/11 | Husband £ | Wife £ |
|---|---|---|
| Cash dividend | 135,000 | 135,000 |
| Tax credit (1/9th) | 15,000 | 15,000 |
| Taxable income | 150,000 | 150,000 |
| Tax @ 10% dividend rate | - | 3,740 |
| Tax @ 32.5% dividend rate | - | 36,595 |
| Tax @ 42.5% dividend rate | 63,750 | - |
| Notional tax credit | (15,000) | (15,000) |
| Net tax liability | 48,750 | 25,335 |
| Effective tax rate on net dividend | 36.11% | 18.77% |
| Tax saving | **£23,415** | |

(Note: The wife receives no personal allowance as her income exceeds £112,950).

This calculation demonstrates that substantial savings can be made if payments are made to a spouse with no income. Indeed, even if a spouse has modest earnings it may still be worthwhile paying them a dividend if it would otherwise be taxed at an effective 36.11% tax rate. For example, on a gross dividend of £100,000 there would be a saving of £10,000 if it were paid to a spouse with income of less than £50,000, rather than to the spouse with income in excess of £150,000.

### Allocating Income

The key question is therefore how to ensure that the right dividends are received by the right spouse. The issue is that dividends must be declared pro rata to an individual's shareholding. Therefore, unless the shareholdings are in the desired proportions, it may be that the spouse with the most income receives the largest share of a dividend.

This issue can be resolved if one spouse waives their entitlement to the dividend in favour of the other. However, HMRC will generally seek to reverse attempts to transfer significant amounts from one spouse to the other in this way.

Instead, this issue can be dealt with if there are different classes of shares so that dividends can be declared at varying rates on the different classes of shares. Ideally, to minimise the risk of attack from HMRC, the company should have been set up with different classes of share from the outset. However, it is still possible for existing companies with only one class of shares to redesignate these into different classes, but great care is needed to achieve this without triggering a tax charge.

### Next Steps

Splitting the income derived from a business between spouses can still achieve a very large tax saving if implemented correctly, despite HMRC's best efforts to the contrary. In addition, the potential tax saving is even greater following the introduction of the new 50% supertax. Accordingly, spouses that own a business or a company should urgently review their tax affairs to see whether they can potentially benefit from this tax saving.

If you are interested in discussing these issues further, then please speak to your usual Rawlinson & Hunter contact.

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