

Arctic Systems: do not spend too long celebrating!

Now this is not the end. It's not even the beginning of the end, but it is perhaps the end of the beginning! Those celebrated words of Churchill aptly sum up where we are with Arctic Systems. The taxpayers have won in the House of Lords but much more is yet to be heard on this topic. HM Revenue & Customs have already said that they will bring forward proposals to change the law and discussions on this will take place.

The facts of the *Arctic Systems* case (or to give it its correct title, *Jones v Garnett*) are well known, but briefly restated they are that Mr Jones was made redundant in 1992 and decided to go freelance. It was decided that he would do this by means of a company called Arctic Systems Ltd and that there would be two shares in the company, one to be held by Mr Jones himself and the other to be held by his wife. Thereafter he worked for the company on a very low salary. Mrs Jones did bookkeeping work for the company and dealt with tax and other financial matters (approximately 4 or 5 hours a week) and the income of the company was distributed on the advice of their accountant for tax efficiency. Mrs Jones took a low salary as well but the profits after deduction of the salaries was largely distributed by means of dividends.

HM Revenue & Customs argued that this all amounted to a 'settlement' as that word is defined to include an arrangement, which they said this undoubtedly was. The Revenue also argued that the exemption from those provisions for outright gifts of assets which are not wholly or mainly a right to income did not apply here. On the latter point, the Revenue said that firstly the wife's share was not given to her by the husband and secondly it was clear that what was going to be produced by her share was the dividend stream and not much else.

The House of Lords unanimously held that there was a settlement or arrangement to which the legislation could apply but the present case was within the exception for outright gifts of an asset which is not wholly or mainly a right to income. Their Lordships held quite conclusively that ordinary shares cannot be assets which are mainly a right to income and so the case was within the exemption.

The important conclusions to be drawn from the House of Lords judgments are as follows:

1. All outstanding cases involving husband and wife companies look safe from attack up to 2005/06. Hopefully, any enquiries which have been opened by the Revenue will now be closed down.
2. The outlook for the future is not good, however. HM Revenue & Customs are set to change the law to reinstate their viewpoint and the only question is the date from which such a change will take effect. It would be much tidier if the change takes effect from the commencement of a new fiscal year, i.e. 6 April 2008, but it is not beyond the bounds of possibility that the date will be sooner, to be

applied to all close company dividends paid after the announcement. In cases where it is decided to pay a dividend as soon as possible ahead of any change in the law, it should be remembered that under section 836, Companies Act 2006 a dividend has to be justified by reference to the accounts of the company; these may be the last annual accounts or interim accounts for the current year, but in the absence of justification by accounts of either type, the dividend is not validly declared.

3. The House of Lords has slightly extended the definition of settlement. In previous cases, such as *Crossland v Hawkins*, there was a fairly clear arrangement to provide a stream of dividends to a family member as part of a tax avoidance scheme. In the present case, Mr and Mrs Jones were to deal with the profits from year to year as might be thought best at the time and there was no clear strategy at the outset to pay dividends equally between them. For example, if Mrs Jones had acquired another substantial source of income, it might well have been better to pay a much larger salary to Mr Jones. Even so, the House of Lords held that this 'we will make it up as we go along' strategy was enough to amount to a settlement. They went so far as to apply hindsight, saying that what actually happened was that substantial dividends were declared in most years and so that confirmed the initial conclusion.
4. The decision in the controversial case of *Butler v Wildin* was approved by their Lordships. In that case, two brothers set up a company for their children and then arranged a property development through the company so that the children's shares became very valuable. The High Court said that this amounted to a settlement by the parents on their infant children and although there was an appeal to the Court of Appeal, this was discontinued on the first day of the hearing when the parties got together and agreed a compromise, the details of which cannot be disclosed here. A key issue in the case was that what the brothers did was to provide their services to the company for nothing; the provision of services does not amount to a settlement, it has to be a provision of funds. It seems from the judgments in the House of Lords in the present case that the High Court decision was approved on the basis that the brothers guaranteed loans to the company and so undertook personal financial risk which was enough to amount to the provision of funds.
5. The exemption for outright gifts in the settlements legislation is, according to the House of Lords, to be construed widely. When Arctic Systems Ltd was set up, the allotment of one share to the wife was to be treated as a gift of that share to her by Mr Jones as in effect that was what it was intended to be. This seems to be a generous, and dare one say even sexist, interpretation when the company was clearly a collaboration between both the husband and the wife. All the same, whilst this brought success in the present case, it looks set to be short-lived in view of the forthcoming new legislation.

6. Since the Revenue won the main point which was that husband and wife companies of this type do amount to a settlement for income tax purposes; the expected change in the law will presumably take the form of an amendment to section 626, ITTOIA 2005, which now contains the exception for outright gifts between spouses. It will be recalled that section 282A, Taxes Act 1988 (income from jointly held property) was amended by the 2004 Finance Act to take close company shares entirely out of the scope of income splitting under that section. The Revenue may be tempted to do the same with section 626, ITTOIA but the result of that for Arctic Systems would be that Mrs Jones could not then have her reward for work performed paid in the form of dividends, whereas Mr Jones could. No doubt this point will be made to the Revenue by the representative bodies.

Refer to our Newsdesk December 2007 article on the Government's proposed legislation following the Arctic Systems case.

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