

# Technical Factsheet 129

## Settlement Provisions and Disclosure Issues

A guidance note on disclosure for self assessment for the year ended 5 April 2005



*Guidance to members of the Chartered Institute of Taxation (CIOT), Tax Faculty of the Institute of Chartered Accountants in England and Wales (ICAEW), Association of Chartered Certified Accountants (ACCA), Institute of Chartered Accountants of Scotland (ICAS), Association of Taxation Technicians (ATT) and Association of Accounting Technicians (AAT) ('the professional bodies') as regards the impact of the settlements legislation (formerly s660A, ICTA 1988 and now in Chapter 5 of Part 5 to ITTOIA 2005) on small businesses.*

**NOTE: This guidance has been passed to Her Majesty's Revenue & Customs (HMRC) for comment and we are grateful for its input. However, this note remains the view of the professional bodies named above and is not in any way endorsed by or binding on HMRC.**

1 The purpose of this note is to update members on the position regarding small businesses and the settlements legislation, as formerly found in s660A, ICTA 1988 onwards. The relevant legislation is now found from s619 onwards of The Income Tax (Trading and Other Income) Act 2005 (ITTOIA 2005). This note replaces guidance offered by the tax representative bodies listed in the first column on this subject on 23 November 2004, which was subsequently updated in January 2005. That previous guidance is now superseded in the light of the High Court decision in *Jones v Garnett* [2005] EWHC 849 (sometimes referred to as the Arctic Systems Ltd case). The previous guidance may give a useful background for those coming fresh to the subject. **This guidance note is intended to assist only with the issue of disclosure and is not a substitute for reading the full decision in *Jones v Garnett*.**

2 The key points to note are:

- (a) the need to consider carefully on a case by case basis the technical issues in the context of members' clients; and
- (b) where the facts of a client's situation suggest that it might be in point, the need to take into account the High Court judgment and its implications.

### **What types of situation are affected?**

3 Anti-avoidance provisions in relation to settlements, now contained in Chapter 5 of Part 5 to ITTOIA 2005, have been around since 1922, but were

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extensively changed following the introduction of independent taxation in 1991. The potential application of these provisions to common commercial situations in relation to small business has only recently become apparent. In response to requests for clarification from the CIOT, what is now Her Majesty's Revenue and Customs (HMRC) published guidance on the application of this legislation to such common situations as husband and wife partnerships and companies in Issue 64 of its *Tax Bulletin* (published in April 2003), in Issue 69 of the *Tax Bulletin* (published in February 2004) and in its document issued on 18 November 2004 entitled *A Guide to the Settlements Legislation for Small Business Advisers* (the 'HMRC Guide'). All of these can be found on [www.hmrc.gov.uk](http://www.hmrc.gov.uk).

- 4 In this context, there are a number of situations to which HMRC says the settlements legislation may apply but perhaps most interesting for our purposes is that where a company is set up with a nominal share capital, owned jointly between husband and wife, or by people living together or closely connected by personal or family ties, and where one of the parties works full-time in the business and the other's involvement is much less significant and they are paying tax at a lower rate. If dividends are then paid on the shares, the HMRC argument, set out in the *Tax Bulletin* articles referred to above (para 3), is that the dividend is 'bounteous' and, as there is no significant capital in the company, what has passed to the part-time working shareholder can be reallocated back to the higher rate taxpayer. HMRC believes that the dividend is then taxable on the full-time working shareholder under the provisions which used to be found in s660A, ICTA 1988. There are potential exemptions for outright gifts between spouses unless the property given

was wholly or substantially a right to income.

- 5 The High Court decision in *Jones v Garnett* has broadly supported the HMRC view in situations involving companies:
- with low capital value
  - where the spouse subscribed for the share
  - where this spouse does no work at all, or relatively little work (Mrs Jones did around 4-5 hours a week)
  - where the remuneration paid to the main income generator is below the market rate for the job (Mr Jones took £6,000 salary out of fee income generated of £90,000); and
  - where the shareholders receive a dividend.

It is also likely that in cases where the share was gifted, but other factors are the same, the legislation will also apply. However, comments on this point by the Judge were given as an aside as they did not relate directly to the facts of the case.

- 6 The decision of Mr Justice Park in the *Jones v Garnett* case is being appealed to the Court of Appeal. There is no certainty that the decision will be available before 31 January 2006, i.e. the last filing date for tax returns under self assessment for the year 2004/05. The following guidance is thus given on the basis of the High Court decision. Should the Court of Appeal decision be heard, and judgment given, before 31 January 2006, then clearly members should review the position in the light of that judgment.

#### **Taxpayers whose position is similar to Mr and Mrs Jones**

- 7 Taxpayers who find themselves in a similar position to that outlined in *Jones v Garnett* (i.e. it is not easy to differentiate their facts from that case) now

have the opinion of a High Court decision which they must consider carefully. This means they will have three possible options:

- i) assess by reference to the settlements legislation (see paras 8 and 9 below); or
- ii) explain that they are not following the decision until the appeal process is completed and the final decision is known (see paras 10 and 11 below); or
- iii) take a view that they are not following that decision but without highlighting this point (para 12 below).

Each of the above three courses of action has consequences which should be considered carefully in light of the circumstances and in consultation with the client.

*i) Assessing by reference to the settlements legislation*

- 8 Guidance on how to include settlement income in self assessment returns was provided by HMRC in the HMRC Guide (see para 3 above).
- 9 If taxpayers self assess under para 8 above and Jones v Garnett is overturned before 31 January 2007 it will be open to them to amend their income tax returns by that date to reflect that the settlements legislation does not in fact apply. If, however, the case is not finally settled until after that date it will not be possible to amend 2004/05 returns as the relevant time limits will have passed. It would be open to taxpayers to make a claim under the error or mistake provisions in s33, TMA 1970 but it is possible that such claims will not be accepted by HMRC because of s33(2A)(a), i.e. that the return was made in accordance with the understanding of the law at that time.

*ii) Taking a view that the case will be overturned and disclosing*

- 10 Another possible way of filing is that the taxpayer, knowing that the case is going to appeal, takes a different view of the law from that stated in the High Court decision. In the recent case of National Westminster Bank plc v Spectrum Plus (House of Lords, 30 June), it was said of the previous court's decision: 'It was a first instance decision and cannot have been regarded as definitely settling the law in that field.' Lord Justice Lloyd, in giving permission for the Arctic Systems Ltd appeal, said that he was satisfied 'that it is a point on which there are substantial arguments either way and that there are therefore reasonable prospects of success on the appeal'. A taxpayer with this knowledge would arguably not be acting unreasonably in self-assessing on the basis that the appeal will succeed, provided that this is made clear in the return. In this instance, the adviser would be working on the basis that the client's position was very similar to that of Mr and Mrs Jones, so that it would be reasonable to adopt this view; there will no doubt also be cases where the facts are different from the Joneses' position with possible different filing positions but again the need must be to make the position taken clear.
- 11 To ensure full disclosure had been made, anyone choosing not to follow the High Court decision could make a clear white space note to that effect. This should preclude HMRC being able to use its powers of discovery in the future in relation to the tax year 2004/05. Possible wording could include: 'Dividends of £X were received by Mrs Y which may be assessable on me under the settlements legislation found in s619 onwards of ITTOIA 2005. These dividends have not been included on my tax return pending the outcome of the appeal in Jones

v Garnett'. Members should alert clients to the fact that interest will arise on unpaid tax if the judicial process finally resolves this issue in favour of HMRC and the possibility of penalties if it is considered that the position taken was not reasonable. Equally clients need to be made aware of the implications of such a white space note leading to an enquiry in relation to previous years.

*iii) Taking a view that the case will be overturned and not disclosing*

- 12 If a taxpayer takes a different view of the law from that stated in the High Court decision, and thus holds that the High Court case will be overturned, they are entitled technically to self assess on that basis and not disclose. However, if Jones v Garnett is not appealed successfully they would then need to repair their return or otherwise disclose if the period for a repair had ended. If this course of action is taken, penalties are more likely to be imposed, plus of course interest. This route would also provide no protection from discovery and it could arguably lead HMRC to contend that the return had been filed negligently if the view taken was not held to be reasonable. We thus do not recommend this course of action.

*Earlier years*

- 13 Where the settlement legislation is in point, consideration will also have to be given to earlier years and advisers are directed to the ethical guidance offered by the accountancy and tax Institutes and Associations listed at the beginning of this guidance on providing appropriate information in such cases. HMRC has been asked to provide guidance on how it will operate in relation to earlier years following the High Court decision in Jones v Garnett but to date there has

been no official information further to the HMRC Guide mentioned in para 3 above.

**Taxpayers where there is sufficient evidence to suggest that HMRC would agree that the legislation does not apply**

- 14 Where a taxpayer's situation can be differentiated from that in Jones v Garnett, the adviser should still consider the view of HMRC as set out in its published guidance. In some cases, the guidance will indicate that HMRC agrees that the settlements legislation does not apply.

- 15 In these cases it will be possible to continue to self assess without reference to the settlements legislation, as it will not be in point, and there will be no need for a white space note. It is important to remember a comment from Mr Justice Park in the High Court decision:

'If a husband and wife set up a joint company and run it together....it does not follow from my judgment in this case that the husband is going to be taxed on the wife's dividends.'

- 16 The sorts of factors which would help show that the settlements legislation did not apply might include the payment of a market salary to the key worker, appropriate capital value in the business or evidence of sufficient involvement by the 'less active spouse' to justify the dividend. However, it is important to remember that no one fact is decisive and it is the overall arrangement which must be carefully considered for retained interest on the part of the key worker and bounty.

**Taxpayers whose situation can be distinguished from the Joneses', but where HMRC may believe the settlements legislation applies**

- 17 These situations will arise where the facts are not the same as in Jones v Garnett but are within the examples outlined in the HMRC Guide - eg a partnership situation akin to Example 20 in the HMRC Guide.
- 18 In such cases a view needs to be taken on the correct level of disclosure required. The Court of Appeal decision in Langham v Veltema [2004] STC 544 appears to make it clear that, in order to avoid discovery assessments in later years, it is necessary to bring the precise point in respect of which protection from discovery is sought to the attention of the officer dealing with the taxpayer's personal tax affairs, and not rely on the information being available to HMRC by other means. The initial HMRC guidance (see para 19) issued in light of Langham v Veltema explains its view on the application of the discovery rule, from which we do not dissent.
- 19 Taxpayers seeking certainty by the anniversary of the filing date therefore need to make sure that the relevant HMRC officer has appropriate information. It is not sufficient that the information may be held elsewhere within HMRC. A guidance note on Veltema was issued on 23 December 2004 and was supported by the professional bodies in the guidance they published on 7 January 2005.
- 20 This was issued prior to the setting up of HMRC and the introduction of ITTOIA 2005 and it states that :
- '... The guidance on discovery is that taxpayers should enter in the Additional Information space comments to the

effect that they have not followed the Revenue guidance in respect of s660A ... Protection can be achieved by noting that 'Revenue guidance indicates that s660A may apply. No adjustment has been made.'

- 21 Going forward, in such cases it would then be up to HMRC whether or not to make an enquiry within the normal enquiry window. For each year for which such a statement is made and which does not lead to an enquiry within the normal enquiry window the taxpayer should be protected from discovery for that year 'unless the stance adopted is wholly unreasonable'.
- 22 In the alternative, a taxpayer may prefer to return the actual income without further disclosure explanations and resist a challenge that the settlements legislation applies from HMRC if one is made within the normal enquiry window or within the five years and ten months allowed for a discovery assessment.
- 23 In the view of the professional bodies, there is no requirement in tax law for a taxpayer to indicate where he has interpreted a doubtful issue in his favour. This presupposes that the return is correct and complete and the non-application of the settlement provisions to reallocate income is a tenable stance.

**Record of discussion with client**

- 24 Members should discuss with their clients the possible application of the settlement legislation where the position is unclear. They should weigh up the comparative disadvantage of provoking an enquiry with a possible discovery assessment covering several years if either the Court of Appeal judgment further extends the decision in the favour of HMRC, or subsequent court cases are decided in

favour of the revenue authority's interpretation of the legislation. It is important that there is a very clear record of the discussions with the client with either a detailed file note or preferably the position clearly explained in a letter to the client with written confirmation from the client as to the basis on which the tax return is to be completed including, in particular, the agreement of the client to the wording of any entry to be made in the white space of the return. Advice given to the client should reflect the position set out in this guidance note.

### **Civil partnerships**

25 This guidance note concentrates on the filing issues faced for those self assessing for the year ended 5 April 2005. It is worth noting that in the future the issues raised here will be relevant to some couples registering a partnership under the Civil Partnership Act 2004 which becomes effective from 5 December 2005.

### **Enquiry insurance**

26 Some practices will operate arrangements under which the costs of handing an enquiry are covered by insurance. We strongly recommend that you discuss the approach which your practice is going to take to tax return disclosure in this area to ensure that your clients remain covered by any insurance.

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