

# Settlement provisions and disclosure issues

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

Issued January 2006

### *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.*



Tax Faculty



THE  
INSTITUTE OF  
CHARTERED  
ACCOUNTANTS  
OF SCOTLAND



The Association of Taxation Technicians

AAT  
ASSOCIATION  
OF ACCOUNTING  
TECHNICIANS

### Introduction

1. The purpose of this note is to assist members with the issue of disclosure on tax returns of income received from small businesses with reference to the settlements legislation. In December 2005 the Court of Appeal unanimously found in favour of the taxpayer in the leading case of *Jones v Garnett* [2005] EWCA Civ 1553 (sometimes referred to as Arctic Systems Ltd). As a result the current legal position is that the settlements legislation does not apply to many small husband and wife businesses in the way originally suggested by what was then the Inland Revenue.
2. Practitioners will thus need to consider their client's 2004/05 self-assessment filing position in the light of the Court of Appeal decision and the recently-announced intention of what is now Her Majesty's Revenue & Customs (HMRC) to apply to the House of Lords for leave to appeal.
3. This guidance note is intended to assist only with this issue of disclosure; specifically it is not a substitute for reading the full decision; neither is it a full review of the settlements legislation and its application to small businesses. It replaces the guidance issued by the professional bodies on this subject on 23 November 2004, which was subsequently updated in January 2005 and September 2005.

### Brief background

4. Anti-avoidance provisions in relation to settlements, now contained in Chapter 5 of Part 5 to The Income Tax (Trading and Other Income) Act 2005 (ITTOIA 2005), and formerly found in s660A, ICTA 1988 onwards, have been around since 1922, but were extensively changed following the introduction of independent taxation in 1991.
5. The view of HMRC as to the potential application of these provisions to many small businesses has only recently become apparent. Their first pronouncement covered the possible application of the legislation to such common situations as husband and wife partnerships and companies, and was set out in Issue 64 of its Tax Bulletin, published in April 2003.
6. The sort of situation to which HMRC object is where a company is set up with a nominal share capital, owned jointly between a husband and wife or 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 yet he or she receives significant dividends from the business.
7. The case of Mr and Mrs Jones and their company Arctic Systems Limited mirrored that in Example 3 of the April 2003 Tax Bulletin.

8. HMRC argued that:
  - the purchase of the company by both Mr and Mrs Jones, so that they each had one share;
  - the provision of Mr Jones's consultancy services to clients through the company;
  - the payment of the modest salaries; and
  - the declaration by the company (of which Mr Jones was the sole director) of dividends

was a definite scheme, the intention of which was to ensure that part of the profits of the company, derived from the work of the appellant, was paid to Mrs Jones in the form of dividends with a consequent saving of income tax, and that this was thus an "arrangement" which fell within the settlements legislation. HMRC thus sought to reallocate Mrs Jones's dividends to her husband for tax purposes, and tax them at Mr Jones's marginal rate.

9. HMRC also held that the situation would be no different if Mrs Jones had been given her one share in the company by her husband, and that the exemption from the settlements legislation contained within s626, ITTOIA 2005 (formerly s660(6), ICTA 1988) for gifts between spouses, did not apply because the gift of a share in this situation would be "substantially a right to income."
10. The Special Commissioners (by casting vote of the senior commissioner) and the High Court agreed with HMRC.

### The Court of Appeal decision

11. In December 2005 the Court of Appeal ruled unanimously in favour of the taxpayer, finding that there was no settlement. At paragraphs 75 and 76 of the judgment, the Chancellor of the High Court said:

"The 'bounty' on which the Revenue necessarily rely is that provided subsequently and in fact by the combination of the demand and charge-out rate for the services of Mr Jones, the salary in fact paid to Mr Jones, the other commitments of the Company and the dividend subsequently declared and paid by the Company to Mrs Jones. All these additional elements depended on the will of Mr Jones or wholly extraneous factors. He did not commit himself to working for the Company at any particular rate of salary or at all. His charge-out rate necessarily depended on the demand for his services and the going market rate. Whether any and if so what profits were made depended not only on the difference between Mr Jones' charge-out rate and salary but the level of the Company's overheads and other commitments. If the Company made profits whether to declare any and if so what dividend was a matter for Mr Jones as the sole director and controlling shareholder.

"For my part, I do not think that these elements can be included in the 'arrangement'. They did not form any part of a structure of things or combination of objects; their uncertainty and fluidity is the converse of an arrangement. It is not that they were not legally enforceable, they were not settled at all. No doubt Mr and Mrs Jones hoped for the best but it cannot be said that they had arranged it. Without these elements there was no element of bounty and no settlement within the statutory definition."

At paragraph 83 he said:

"In the absence of any service agreement between the Company and Mr Jones I am unable to accept that the payment of modest salaries to Mr Jones was any part of the arrangement. Similarly the declaration of the dividends was not arranged in advance; it was dependent on the trading fortunes of the Company. Further, as counsel for Mr Jones submitted, and, as I accept, the fact that the structure being set up might lend itself in the future to some tax mitigation is irrelevant to the existence of an element of bounty."

12. The Chancellor also commented on what the position would have been had this not been the case, and Mr Jones had given a share in the company to Mrs Jones. He concluded that the share would have been covered by the exemption for gifts between spouses set out in s626, ITTOIA 2005, and was not "substantially a right to income" (paragraph 97 of the judgment.).

13. The other two judges gave supporting judgments. Lord Justice Keene said:

"What happened in practice was therefore dependent on subsequent decisions made by the appellant as the sole director. It is difficult to regard such a Protean state of affairs as capable of being part of an arrangement in the sense used in the legislation."

#### HMRC position

14. On 13 January 2006 HMRC announced that they are seeking leave to appeal the decision to the House of Lords. They may, or they may not, receive permission to appeal. Because the case may still be reversed in their favour, they have said that it is "premature" to amend their earlier guidance on how they consider that the settlements legislation affects small businesses.

#### Self assessment – general

15. The current legal position is that the settlements legislation does not apply where the key facts of a client's case are on all fours with those which formed the basis of the judges' decision in the Arctic case.

16. However, there may be cases where key facts are different from those in Arctic. Tax advisers should thus consider their clients' position carefully.

#### Self-assessment where client's case similar to the Joneses's in key areas

17. Representations made to the professional bodies over the last two and a half years by members have indicated that many small businesses are in very similar position to the Joneses. In particular, the level of uncertainty and fluidity as to what would happen in the future means that in many family companies there is no arrangement in the sense contemplated by the legislation.

18. Where this is the position, there is no requirement for the taxpayer to self-assess under s624, ITTOIA 2005 in relation to dividends paid to his/her spouse, or to include any information relating to these dividends on his/her tax return (they should, of course, be included on the tax return of the receiving spouse in the same way as other dividends).

19. Members should, however, alert clients to the fact that if the judicial process finally resolves this issue in favour of HMRC, the return may have to be repaired (or the information otherwise disclosed if the period for repair has ended) and that interest will arise on unpaid tax; there is also the possibility of penalties if HMRC consider that the position taken was not reasonable.

#### Amending returns

20. It is possible to amend any already submitted tax returns for the year ended 5 April 2005 (2004/05 returns) to reflect the new developments in *Jones v Garnett*. This amendment is possible up until 31 January 2007. You may wish to amend a return where a view had previously been taken that the settlements legislation applied, but now wish to file on the basis that it does not apply, in the light of the Court of Appeal decision. One needs to be careful in such cases to ensure that the client's situation did fall within the ambit of the judgment. It is also possible to amend 2003/04 returns up until 31 January 2006 in the same way before the window for making amendments expires for that year. Clearly, it remains possible that the Court of Appeal judgment could be overturned, in which case a further amendment would be required.

#### Earlier years

21. If earlier returns have been filed on the basis that the settlements legislation applies, but this is no longer thought to be the case, you may wish to consider whether to claim under the error or mistake provisions of s33, TMA 1970. It is unclear whether HMRC will accept such a claim.

**Self assessment where there is uncertainty as to whether a client's position is sufficiently similar to that in Arctic Systems**

22. If the published guidance of HMRC indicates that a client is, in their view, within the settlements legislation, but there is uncertainty as to whether the Arctic decision applies to a client's case, a view needs to be taken on the correct level of disclosure required.

*(a) White space disclosure*

23. 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.

24. 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.

25. A guidance note on *Veltema* was issued by the Inland Revenue (as it then was) on 23 December 2004 and was supported by the professional bodies in the guidance we published on 7 January 2005. This guidance explains HMRC's view on the application of the discovery rule, from which we do not dissent.

26. This guidance 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.'"

27. 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."

28. Possible wording for the white space disclosure could include: "Dividends of £X were received by Mrs Y which may be assessable on me under the settlements legislation found in s624, ITTOIA 2005. These dividends have not been included on my tax return pending the final decision in the *Jones v Garnett* case".

29. A white space disclosure note can be put on any appropriate white space on the tax return.

30. Again, 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; there is also the possibility of penalties if it is considered that the position taken was not reasonable. In addition, clients need to be made aware of the implications of such a white space note leading to an enquiry in relation to previous years if HMRC are ultimately successful.

*(b) No white space disclosure*

31. 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.

32. Thus taxpayers in this position may choose not to make a white space disclosure. They would then return the dividends as income of each spouse and seek to resist a challenge from HMRC if one is made within the normal enquiry window (or within the five years and ten months allowed for a discovery assessment where this applies).

**Record of discussion with client**

33. 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.

**Insurance**

34. Many 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 insurance.

**The Chartered Institute of Taxation/ICAEW Tax Faculty/  
ACCA/ICAS/ATT/AAT**