

A Recent Interesting UK Tax Case that went to the Law Lords:  
From an article on the UK MSN site:

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### **Background (by Anderson Whittle)**

It is fairly common in the UK, where dividends are taxed in the shareholders hands (and not at source like in SA with STC) for business owners to ensure that the shares of a small company are jointly held by spouses. This means (in the case of the husband working) the wife would have a low tax rate, and the dividends would be taxed at a low rate in her hands rather than her husbands. The UK IRS objected to this (widely used) UK business practise - see the UK tax case below, but the Law Lords ruled in favour of the taxpayers. We feel that the UK IRS may amend tax legislation in future to deem the income to have been received by the husband.

In South Africa, Anderson Whittle will usually structure these type of arrangements in other ways.

### **Would the Law Lords rule in favour of HM Revenue & Customs (HMRC) in its battle against a married couple who owned a small business?**

The implications of such a decision could have resulted in an estimated 30,000 business couples collectively facing a £1 billion tax bill. In the event, the Lords sided with Arctic Systems, owned and run by Geoff and Diana Jones, effectively leaving HMRC out in the fiscal cold. So, celebration time for husband and wife partnerships (gratingly also known as 'mom and pop' companies) who utilise a long-recognised tax-saving arrangement? Alas, no. Just the one cheer perhaps; it would seem that a financial cold spell is just around the corner.

Within 24 hours of the Law Lords ruling last month, the Treasury announced a wholesale re-evaluation of the common practice whereby business couples pay themselves low salaries and draw higher dividends in order to maximise tax efficiencies.

Accusations of taxman mean-spiritedness and condemnation of HMRC as sorry rule-changing losers won't cut any ice, although Mr Jones predicted that subsequent changes to tax laws would not negate Arctic's success: "If the law changes and it starts from a particular date in the future, that is preferable to the arbitrary, back-dated decision the Revenue made in our case."

New tax rules are unlikely to apply retrospectively. In the Jones' case HMRC attempted to seek some £10,000 in back taxes, revised down from an initial demand for £42,000 sent to the West Sussex couple in 2003.

Thousands of businesses structured in the Arctic mould should now feel safe from a sudden back-tax chill, but can expect, according to tax experts, future testing by the Revenue of the legitimacy of their business arrangements.

It is likely that circumstances will be compared to non-family companies and the exemption that applies to married couples will be removed.

The Joneses set up Arctic Systems, an IT consultancy, with equal shares. Annual turnover was around £100,000. Following a long-established tax-reduction method, Mrs Jones was paid a low salary enabling her to become a basic rate taxpayer. Thus there was more money left in the business to distribute as profits or dividends to shareholders each year.

Mr Jones didn't enjoy an extravagant salary either. In fact, counsel for HMRC argued that it was "inadequate" given that he was "solely responsible" for the income generated by the company. In one particular year Mr Jones drew a salary of £6,250, along with a dividend payment of £25,700. His wife, who handled the admin side, took £3,600 in salary, but also received £25,700 in dividends. The Revenue's argument was that, as Mr Jones did the majority of the work, the dividends represented income he had earned and thus were taxable at his higher rate. Effectively, he was giving his wife a chunk of his own earnings paid as dividends, which attract a lower rate of tax and are not subject to National Insurance.

Being a basic-rate taxpayer, Mrs Jones also paid less tax on her dividend share; 10% as compared with 32.5% for higher-rate tax payers. The Revenue had brought the case because, under existing rules, married couples are not allowed to transfer income or earnings in order to pay less tax, or to use another's tax-free allowance.

The Law Lords disagreed, ruling in favour of the Joneses because of the way they had structured their company. They ruled that what was happening wasn't just a case of transfer of income - Mrs Jones held an actual share in Arctic Systems with all the attendant rights of such a holding. The exemption for gifts between spouses applied; dividends paid to Mrs Jones were therefore not income arising under a settlement.

The Treasury has responded by saying it will be "bringing forward proposals for change to legislation" and there will be "greater clarity in law regarding the tax treatment of 'income splitting' arrangements". Some tax experts are not surprised at this move, since the existing situation creates an inequality between ordinarily employed couples and those couples with their own businesses.

Tax-wise, married couples who do not run a company together are treated less favourably. Income splitting by couples is allowed in the UK where investment returns are concerned.

Arguably the concept could be extended to earned income for all couples, whether or not running their own business (as it is in Ireland and the US). But don't hold your breath. It's more probable that legislative changes will take more tax from small businesses rather than confer the same benefit to all married couples.

Perhaps a higher rate of tax will be exacted from dividends or they might become subject to National Insurance Contributions. At present dividends, rather than a salary, provide a far more tax-efficient way of withdrawing funds from a company (this discrepancy was exacerbated by Gordon Brown's hiking of NIC rates when he was chancellor).

Thanks to the Law Lords' ruling, small businesses are safe from a tax clawback

and remuneration arrangements such as used by Arctic Systems remain legal. But for how long? Watch out for a pre-Budget announcement in November.

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