

HMRC spotlight on school fees 'schemes' (Lecture P1384 – 14.05 minutes)

HMRC has recently published a Spotlight (62) on a tax avoidance scheme relating to school fees. To put this in context, the Spotlight regime was instigated some years ago by HMRC where the department has identified a scheme which they believe does not work. These are schemes which HMRC has not yet had the opportunity to formally challenge but where they are indicating, in advance, that they will enquire into any taxpayer who has utilised the planning. So, these are meant to act as a warning. If someone uses a scheme which has been highlighted by a Spotlight, it is likely HMRC will argue that a deliberate offence has been committed and so penalties will be higher if it is shown not to work.

In addition, the promoters of such schemes may have to comply with DOTAS (the Disclosure of Tax Avoidance Schemes) although it is important to note that there is only a requirement under DOTAS if the scheme meets one of the prescribed hallmarks. It is possible that it falls under hallmark 9 relating to financial products. Any person who has already promoted such schemes to clients may need to consider if making a protective notification under DOTAS as a promoter.

Promoters may also be pursued under the 'enablers' regime if this type of scheme is promoted widely.

Not all schemes highlighted by Spotlights reach the point where they are considered by the Tribunal or GAAR panel. It is unclear why this might be the case – that people are put off or simply settle with HMRC where it has been used or HMRC decide in the end that it does not merit challenging.

This Spotlight is interesting because it highlights something which is common enough that many people will have considered this type of planning.

HMRC's view on how the scheme works (taken from the Spotlight)

The arrangements seek to avoid tax by allowing the directors, who are also the main shareholders (the owners) of a company, to divert dividend income from themselves to their minor children.

The arrangements work as follows:

1. a company issues a new class of shares which usually entitles the owner of the shares to certain dividend and voting rights;
2. Person A, usually a grandparent or sibling of the company owner, purchases the new shares for an amount significantly below market value;
3. Person A usually gifts the shares to a trust or declares a trust over the shares for the benefit of the company owner's children;
4. Person A or the company owners vote for substantial dividend payments in respect of the new class of share;
5. this dividend payment is paid to the trustees of the trust;
6. as the beneficiaries of the trust, the company owner's children are entitled to the dividend.

The company owner's children pay tax on the dividend received. However, they pay much less tax than if the company owners received the dividend due to their children's:

- £12,570 tax-free personal allowance;
- £1,000 dividend allowance;
- eligibility to the dividend basic tax rate.

Spotlight 62 goes on to say that it is HMRC's view that this is caught by the settlements provisions and states that arrangements which operate in a similar way may also be caught by this legislation. There are no further details about the specific technical arguments which HMRC might use.

Income from a settlement

S.629 ITTOIA 2005 states that income from a settlement is treated as the income of the settlor where it is paid for the benefit of the relevant children of the settlor.

The definition of settlement is 'any disposition, trust, covenant, arrangement or transfer of assets' and can include a series of transactions. The use of the word 'arrangement' within this definition means that it covers a wide range of situations and it would not be advised to rely on being able to argue that this is not an arrangement. A settlor is any person who makes a settlement. It is well established that this can include someone who is indirectly involved.

The use of grandparents to subscribe for the shares and then transfer those to the settlement from which their grandchildren benefit was always thought to avoid the application of those provisions.

However, the argument made by HMRC here may well derive from the fact that the parents of the children have allowed valuable shares in the company to be issued at less than market value so that they are, in fact, also an indirect settlor in relation to the settlement.

The 1988 case of *Butler v Wildin* BTC475 considered this argument. Two brothers (one who was an accountant and one who was an architect) held shares in a company which also issued shares to their minor children using funds provided by their grandparents. They developed a property and dividends were paid out to their children which the Courts found were caught under the Settlements provisions. The fact that the brothers worked for the company for no consideration, and therefore inflated the profit available for distribution to their children, was found to be an arrangement within these provisions as they had intended to confer a benefit on their children by not being paid for what they did.

There is also an example in the HMRC Trusts Settlements and Estate Manual at paragraph 4300 which states:

Mr J owns 60 of the 100 issued £1 shares in J Limited. Mr J is the sole company director and is the person responsible for making all the company's profits because of his knowledge, expertise and hard work. On starting up the company, Mr J allowed his mother to subscribe £40 for 40% of the shares and shortly afterwards she gifted them to her grandchildren... The true settlor here is Mr J rather than the children's grandmother. S.629 therefore applies and attributes the dividends received by the children to Mr J for tax purposes.

This example suggests that the 'scheme' which is being attacked would include situations where the shares are issued at a time when a company has no value and no distributable reserves.

Further guidance (at para.4325 of the same manual) states that HMRC will look at situations where the following apply:

- disproportionately large returns on capital investments;
- differing classes of shares enabling dividends to be paid only to shareholders paying lower rates of tax;
- dividends being waived so that higher dividend;
- income being transferred from the person making most of the profits of a business to a friend or family member who pays tax at a lower rate.

This is wider than the specific circumstances outlined above but HMRC do acknowledge (as noted above) that other similar arrangements which operate in the same way may also be caught. On this basis, this type of planning may now become too risky. Advisors may also need to consider if they wish to continue to pay dividends on shares where this structure has been put in place in the past.

Contributed by Ros Martin