

Tax-free distributions? (Lecture P1363 – 16.26 minutes)

The Upper Tribunal case of *Clipperton v HMRC* (2022) involved two individuals who were 50: 50 shareholder directors of a company called Winn & Co (Yorkshire) Ltd (WY) carrying on a successful accountancy practice. HMRC had assessed the two of them – Sharon Clipperton (C) and Steven Lloyd (L) – to income tax in respect of sums received in 2011/12 from WY. C and L appealed these assessments to the First Tier Tribunal. Their dispute was heard in December 2018, but judgment was not given until January 2021.

The taxpayers appealed against the First Tier Tribunal's decision (which largely went against them) and HMRC in turn cross-appealed on a particular matter.

The facts of the case were not in dispute and may be summarised as follows. WY had historically paid C and L substantial dividends from the company's business profits, e.g., £300,000 in respect of the year ended 31 May 2010.

However, the two shareholders subsequently adopted a plan, marketed by a company called Premier Strategies Ltd, designed to enable companies to put into the hands of shareholders money, which would otherwise have been taxable as distributions, without any charge to income tax. This was described as a 'dividend replacement strategy' and relied on the legislation in s.s619 – 648 ITTOIA 2005 operating to the advantage of the scheme users.

The relevant steps, which took place over a period of one month, were:

- WY subscribed for 199 'A' ordinary shares of £1 each and one 'B' ordinary share of £1 in a newly formed subsidiary called Winn Scarborough Ltd (WS).
- WY settled the 'B' share on trust largely for the benefit of the two accountants but on the basis that the company was entitled to receive a small amount of any income arising to the trust and that the trust property was to revert to it.
- WY subscribed for one additional 'A' share in WS at a premium of £200,000.
- WS's share capital was then reduced by £200,000 through the cancellation of the share premium account which had just been created and this amount was credited to the company's distributable reserves.
- WS declared a dividend of £200,000 on the 'B' share, using the distributable reserves produced by the capital reduction.
- The trustee of the trust paid the sum which it received as a dividend to the two beneficiaries. The amount which each of C and L received was £98,465, referred to as 'the income in dispute' (the balance of the dividend payment was used to settle bank transfer fees and to hand over small amounts to a designated charity and to WY).

The appellants disclosed details of the above arrangements in their self-assessment tax returns for 2011/12. They took the view that they were not taxable on the relevant receipts –

The success of this scheme depended on the settlements legislation in ITTOIA 2005 treating the income arising under the settlement as the income of the 'settlor'.

The intention was that:

- WY was the settlor of the trust;
- income arising under the trust would be deemed to be income of WY;
- the dividend declared by WS would be income of WY alone; and
- no tax would be payable by WY, given that companies do not pay tax on dividends and other income distributions which they receive.

The result was that the trust payments to C and L were ostensibly free of income tax.

The Clipperton dispute is the lead case for a number of other appeals using similar arrangements.

Disputing the beneficiaries' contention, HMRC's position was that C and L were liable to pay tax on the income in dispute for the following reasons:

- On a purposive construction of the legislation, this income constituted a distribution made by WY to each of the appellants within the meaning of ss.383 – 385 ITTOIA 2005 and S1000 CTA 2010. As a result of the line of cases starting with *WT Ramsay Ltd v CIR* (1981) which established the above principle, this reasoning is referred to as HMRC's 'Ramsay argument'.
- The settlements code applies to impose an income tax charge on C and L (and not WY) in relation to their disputed income on the basis that the two individuals were the real settlors of the settlement, given that they (as the sole shareholder directors of WY) arranged for all the steps involved in the scheme to be put in place. This is referred to as HMRC's 'settlement argument'.

The First Tier Tribunal judge found in favour of HMRC on the Ramsay argument, deciding that the 'B' share dividend was taxable as a distribution made by WY to the two appellants.

As far as the interaction between the distribution provisions and the settlements code was concerned, the judge concluded that the corollary of the finding about the distribution was that the income should not be regarded as arising under a settlement made by WY as settlor.

If the above argument was incorrect, the arrangements did create a settlement, but, in the judge's opinion, WY was the sole settlor of that settlement so that the income could not be apportioned to C and L.

As has been seen, the appellants were unsuccessful at this level because of the Ramsay argument. However, HMRC were unhappy with the finding that, if the settlements legislation had to be considered, the settlor was the company (WY) and not the two shareholder directors (C and L) – hence the appeal and the cross-appeal.

The judges in the Upper Tribunal held that the First Tier Tribunal's decision to approve HMRC's Ramsay argument was fully justified. WY had made a distribution out of assets in respect of shares to the two appellants. The detailed analysis of the case law beginning with *WT Ramsay Ltd v CIR* (1981) was accurate. Under the Ramsay principle, the income was a direct distribution rather than income from a settlement. C and L's appeal on this ground was dismissed.

The Upper Tribunal also determined that, where the distribution provisions were in point, the existence of the settlements legislation did not stop those provisions from taking effect.

In this context, the First Tier Tribunal had concluded that C and L were not settlors as a result of the judge's analysis of the settlements code. The appellants, the judge said, had not provided an element of bounty to WY. The Upper Tribunal disagreed. C and L had provided an element of bounty. In the words of the judges:

'The fact that the bounty was small, or that it was a tax-driven payment, did not mean that there was not an element of bounty on behalf of the appellants when making the settlement in relation to both WY and Cancer Research (the relevant charity). There is no authority in the case law to suggest that some sort of judicially-defined de minimis threshold applies. If, for instance, the . . . scheme had been utilised for a company with £100 million of funds, would the payment to WY and the charity of £1.5 million have been "small" or "immaterial"?''

The Upper Tribunal set aside the First Tier Tribunal's decision on this issue and remade it, determining, as one commentator remarked, 'that, if the sums were not taxable as distributions, the taxpayers were settlors of the settlement'.

The taxpayers' appeals were dismissed and HMRC's cross-appeal was allowed.

Contributed by Robert Jamieson