

Settlements legislation refresher (Lecture P1362 – 31.52 minutes)

The provisions of the so-called 'settlements legislation' are found in ss.619 – 648 ITTOIA 2005. The first part of these income tax anti-avoidance rules saw the light of day in the 1930s, with subsequent elements appearing on a piecemeal basis thereafter. They were finally rationalised in 1995 before being re-enacted into what one commentator has called 'plain English' by ITTOIA 2005.

Ss.619 – 648 ITTOIA 2005 apply to 'settlements'. The meaning of 'settlement' is very widely defined in S620(1) ITTOIA 2005 as including 'any disposition, trust, covenant, agreement, arrangement or transfer of assets' and 'settlor' refers to the person by whom the settlement was made.

Any income arising from a settlement is deemed to be the settlor's income for income tax purposes if that individual (or their spouse/civil partner) has retained an interest in the settled property (ss.624 and 625 ITTOIA 2005). It should be noted that the definition of 'settlement' extends well beyond the creation of a trust. For example, it is far-reaching enough to catch arrangements such as dividend waivers.

The rules are designed to prevent a person passing income, by means of a settlement, to another person who is not liable to tax or who is taxable at a lower rate than the settlor.

However, a fundamental principle is that what judges have called an 'element of bounty' must be present in order to allow HMRC to invoke the settlements code. This can be demonstrated by considering the decisions in *Bulmer v CIR* (1966) and *CIR v Plummer* (1979).

A settlor is regarded as having an interest in settled property if there are any circumstances in which the property, or any related property, is or may become payable to the settlor (or their spouse/civil partner). This does not mean that the income has had to be paid to the settlor, merely that he is taxed on the relevant amounts which are treated as forming the highest part of his total income (s.619A ITTOIA 2005).

In HMRC's view, the rules apply to any arrangement for income to be payable to a person other than the settlor, provided that:

- the settlor has an interest in the settlement;
- tax is saved; and
- the arrangements are:
 - bounteous; or
 - not commercial; or
 - not at arm's length; or
 - in the case of an outright gift between spouses or civil partners, wholly or substantially a right to income (see s.626 ITTOIA 2005).

These details are confirmed in Para TSEM4200 of the *Trusts, Settlements and Estates Manual*.

Illustration 1

Clarissa is a top rate taxpayer who owns all the 100 ordinary shares in Clarissa Products Ltd.

She wants to give her brother (a basic rate taxpayer) £25,000, but all her money is tied up in the company.

To avoid an additional rate charge on dividends paid out of Clarissa Products Ltd, Clarissa transfers 50 of the ordinary shares to her brother on the understanding that the shares are to be returned to her in one month's time.

In the meantime, Clarissa declares, and her company pays, a dividend of £500 per share so that £25,000 is paid to each shareholder.

The plan, under which the gifted property is expected to be returned to the donor, represents a 'settlement' arrangement where the donor, i.e., the settlor, has retained an interest in the property so that the dividend income paid to the brother is deemed to be the top slice of Clarissa's total income for the tax year in question under ss.624 and 625 ITTOIA 2005. It is not regarded as her brother's income.

By virtue of s.625(4) ITTOIA 2005, a settlor's spouse or civil partner does not include:

- a spouse or civil partner from whom the settlor is separated under a Court Order or a separation agreement;
- a spouse or civil partner from whom the spouse is separated in circumstances which are likely to be permanent;
- the widow or widower or surviving civil partner of the settlor;
- a person to whom the settlor is not married but may later marry; and
- a person who is not a civil partner of the settlor but may later become one.

In practice, HMRC normally accept that a separation of at least 12 months is likely to be permanent.

The Arctic Systems case

During the 1990s, HMRC started to attack income-shifting arrangements under which dividends were provided to the spouse of the individual who owned and ran a successful company. It was typically facilitated either by the creation of a new class of shares or by the person who controlled the company transferring some of their existing shareholding to the spouse. HMRC invariably argued that this planning, even where it involved ordinary shares, was caught by the settlements legislation and so it was not surprising that, before long, a test case arose. This was of course *Jones v Garnett* (2007) which was finally decided by the House of Lords in favour of the taxpayer and is often referred to as the Arctic Systems case (after the name of the company which the taxpayer used).

In this context, it is worth recording some of the important points which arose from the case:

- In Arctic Systems, the Courts at each level concluded that there was indeed an arrangement which, as already mentioned, is the first step to establishing a settlement so that the provisions of ss.624 and 625 ITTOIA 2005 can be invoked.

There seems to be a widespread misconception that the reason for the taxpayer's victory was the absence of an arrangement, but this is not true.

An arrangement existed in the sense that the taxpayer (Mr Jones) acquired a company from company formation agents, that Mr Jones and his wife each purchased a single share for £1, that Mr Jones generated all the company's profits through his work for which he was paid a modest salary and that, after allowing for corporation tax, the company's profits were distributed on a 50:50 basis as dividends.

- Not only was there an arrangement, but an element of bounty was clearly present. Why else would Mr Jones, as the company's sole director, have allowed his wife to acquire 50% of the company and receive 50% of the dividends when he earned all the profits?
- The real reason for the taxpayer's success was that all five of the judges in the House of Lords held that the important exemption in what is now S626 ITTOIA 2005 applied. This let-out was introduced as part of the independent taxation reforms which took effect on 6 April 1990, specifically to enable spouses to make outright gifts to each other without fear of these rules being applied.

Paraphrasing the section, the settlements legislation is not in point if:

1. there is an outright gift of property from which income arises;
2. made by one spouse to the other; and
3. which meets two conditions – namely that the gift carries the right to the whole of the underlying income and that the property is not wholly or substantially a right to income.

On this last point, Lord Hoffmann, who delivered the leading judgment in the House of Lords, concluded his speech with these words:

'Finally, (HMRC) say that the property given, i.e., the share, was "wholly or substantially a right to income". It is true that the value in the share arose from the expectation that it would generate income. But that is true of many shares, even in quoted companies. The share was not wholly or even substantially a right to income. It was an ordinary share conferring a right to vote, to participate in the distribution of assets on a winding up, to block a special resolution, to complain under (S994 Companies Act 2006). These are all rights over and above the right to income. The ordinary share is different from the preference shares in *Young v Pearce* (1996), which conferred nothing except the right to 30% of the net profits before distribution of any other dividend and repayment on winding up of the nominal amount subscribed for their shares. Those shares were substantially a right to share in the income of the company.

In my opinion, this arrangement falls within the exception in (s.626 ITTOIA 2005). I would therefore dismiss the appeal.'

An important planning point can be derived from the words of Park J in the High Court hearing. He emphasised that the settlements legislation is only relevant where the parties are husband and wife (or civil partners). He said that 'if Mr Jones' co-shareholder was not his wife but, say, his sister, he could not be taxed on her dividends'. This may be a salient matter to bear in mind when advising on the structure of a family company.

Income paid to unmarried minor child of settlor

Splitting income between a parent and a minor child is never easy, unless the income is surplus to the family's immediate requirements and can be accumulated until the child reaches the age of 18. This follows from s.629 ITTOIA 2005. The section provides that income arising under a settlement which, during the life of the settlor, is paid to, or for the benefit of, an unmarried minor child of the settlor is to be treated as income of the settlor. There is a de minimis exemption of £100 per tax year. However, if the aggregate sums paid to, or for the benefit of, the child in any one tax year exceed £100, the full amount is treated as the parent's income. The term 'settlement' is defined in the same way as it is for s.624 ITTOIA 2005 purposes and thus covers income-producing assets gifted to minor children as well as trusts set up for their benefit. In this context, 'child' includes a stepchild, an adopted child and an illegitimate child (but not a foster child).

It is worth highlighting that income, which was originally received by the trustees of a children's settlement before the young beneficiary's 18th birthday, would have been taxed in the trustees' hands at the appropriate rate(s). As long as this income was accumulated and not paid out to, or for the benefit of, the son or daughter until the child attained the age of 18, it will then be treated as the child's income (and not the parent's). This can be a useful way of helping to finance, for example, university costs.

Other tax-efficient arrangements include trusts created by remoter relatives such as a grandparent or an uncle (or aunt).

Earnings of a child are not caught by the settlement rules nor are chargeable gains. If a parent gifts funds to a child direct, but they are invested for capital growth rather than income, there is no equivalent provision to s.629 ITTOIA 2005 in the CGT legislation. A child has their own annual CGT exemption and their own 10% and 20% CGT rates, and any gain is treated as the child's.

Capital sums treated as income of settlor

Ss.633 – 643 ITTOIA 2005 contain provisions aimed at preventing the settlor obtaining any benefit from a settlement in which the income may be taxed at a lower rate than that which would have applied had the settlor himself retained it. With the present trust rate of 45%, it is questionable whether this legislation still serves any useful purpose.

In effect, capital payments to a settlor (or to his spouse/civil partner) are matched with the undistributed income of the trust fund at the end of the tax year and taxed as the settlor's income. This sum is grossed up at 45%.

A capital sum means any sum paid:

- by way of loan (whether or not on commercial terms) or a repayment of a loan; and
- otherwise than as income and which is not paid for full consideration in money or money's worth.

A capital sum is only caught to the extent that it is equal to, or less than, the undistributed net income in the settlement. Any excess is not caught in the tax year in which the capital sum is received, but it may be charged later if income arises in the settlement in any of the next 10 tax years. Any part of the capital sum which is not matched within this 10-year period cannot be treated as income of the settlor.

Illustration 2

The undistributed net income of Patrick's settlement is as follows:

	£
Year 1	12,000
Year 2	nil
Year 3	10,000
Year 4	nil
Year 5	8,000

In Year 3, the trustees lend Patrick £48,000. This loan is a capital sum and therefore Patrick is liable to income tax in Year 3 to the extent that there is 'available income', i.e., the undistributed net income of the settlement. At this stage, the available income is £12,000 + £10,000 = £22,000. Thus, Patrick is taxed on £22,000 grossed up for 45% tax (i.e. $£22,000 \times 100/55$) which comes to £40,000. The remaining £48,000 – £22,000 = £26,000 is carried forward and assessed in subsequent tax years when income becomes available. For example, in Year 5, £8,000 is available and so Patrick is taxed on $£8,000 \times 100/55 = £14,545$. If the loan is repaid, there can be no further charge. However, the income tax paid during the loan period cannot be recovered (s.638 ITTOIA 2005).

Contributed by Robert Jamieson