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Husband and Wife Businesses

HM Revenue & Customs (HMRC) has shown great interest in businesses where both spouses are owners (either as shareholders or partners) but one spouse is considerably less active within the business than the other.

Their weapon was the *settlements legislation* which HMRC will seek to apply where one spouse (the *settlor*) enters into an arrangement to divert income to the other spouse and in the process tax is saved. There has to be an element of *bounty* (i.e. "something for nothing").

On the face of it, all transfers between husbands and wives could potentially be settlements. However, there is a statutory exemption where property passed to a spouse is an outright gift, *unless*

- the gift does not carry the right to the *whole* of the income arising (i.e. income could still be payable to either spouse), *or*

- a gift between spouses is wholly or substantially a *right to income*

The legislation is not new, but was originally enacted in the 1930s and brought up to date in the 1990s.

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Legal testing

The well publicised case of Jones v Garnett (*Arctic Systems Ltd*) was decided in the taxpayers' favour. The House of Lords found that, although the wife's share in the company was a settlement, it was not caught because it had been an outright gift.

It may be helpful to consider the basic situations which may involve income shifting:

- Main earner drawing a low (non-commercial) salary leading to enhanced profits from which dividends can be paid to spouse shareholder.
- Differing classes of shares enabling dividends to be paid only to spouse paying lower rates of tax.
- Dividends being waived so that higher dividends can be paid to spouse paying lower rates of tax.
- Dividends paid on shares that carry only restricted rights.

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Income shifting is less likely to be in point:

- If the shares have considerable capital value
- If the main earner draws a commercial salary before dividends are declared

If income shifting is proven:

The income of the lower taxpayer is taxed as income of the donor of the gift (the settlor).

Commentary

Until the Arctic Systems case was finalised the application of the settlements legislation was largely untested. Several anomalies had been put forward:

- settlements by husbands on wives (and vice versa) are subject to rules which do not apply to settlements between any other relatives or friends. It is therefore discriminatory against married couples
- this approach contrasts sharply with the freedom available to married couples or civil partners in transferring assets between themselves without any capital gains or inheritance tax liabilities

- HMRC have sought to extend the application to partnerships, even though a partnership share is not a transferable asset

- unlike the view taken by divorce courts, HMRC's stated approach completely ignored the sacrifices that may be made by the "non-working" spouse in enabling the business to function at all

- for instance agreement to personal (matrimonial) assets being pledged as security for the purposes of the family business, as well as looking after the home and children etc

- ordinary shares do not carry with them a "right" to income; they carry a right to participate with other shareholders in the running of the company and to share in whatever assets remain in a winding up

- although shares transferred to a spouse may be considered to be substantially a right to income in the early days of a company, a successful company may well grow so that eventually the capital value of the shares may greatly outweigh the dividends received

Prevention

- a stronger position may be created if husband and wife both subscribe for shares when the company is formed and both are directors from the outset

- make sure all shares carry voting and capital rights

- there is an argument for husband and wife receiving equal directors' fees rather than salaries and therefore not being employees, particularly if this is evidenced by a commercial agreement

- the position is also strengthened if husband and wife receive equal dividends

- aim to have the “non-earning” spouses involved in the business as much as is practical, thereby giving full value for any money received

- a company with substantial assets which generate income, or retained profits, is not so likely to be caught