CLIENT BULLETIN

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HUSBAND-AND-WIFE COMPANIES

At the end of July the House of Lords gave their judgment in the long-running *Arctic Systems* case. Shortly put, the case concerned a freelance computer programmer, Mr Jones, who conducted his business through a company, Arctic Systems Ltd. The bulk of the money earned was paid out as dividends and, as Mrs Jones owned half the shares in the company, this meant that the taxable income was equally divided between husband and wife, eliminating the higher-rate tax that would have been payable if all the money had been taxed as Mr Jones' income.

The Revenue had claimed that some convoluted anti-avoidance legislation, originally designed to block tax avoidance through the use of family trusts, had the effect of deeming Mrs Jones' dividends to be Mr Jones' income for tax purposes. This claim was rejected by the House of Lords, who held that each spouse was taxable on the dividends he or she actually received.

The case was, of course, a test case and the decision will affect many thousands of similar small enterprises. However, the very next day the Government announced that they found the Judges' decision unacceptable and that they would legislate to reverse it. That said, it appears that the new legislation will not be retrospective, and probably will not come into force until next year, so at least there is no question of the Revenue being able to charge additional tax for back years.

The Revenue's traditional approach has been that there is a clear distinction between the *Arctic Systems* scenario, where one spouse earns the money and the other at most provides support services, and a 'genuine family business' where husband and wife jointly run an enterprise such as a shop. In the *Arctic Systems* scenario, the Revenue have attempted to limit the income allocated to the 'support spouse' to the value of the work she (usually, but it could be he) contributes, but in the case of a 'genuine family business' they have not sought to challenge the way profits were divided between the spouses.

First indications are that the new legislation will attack all 'non-commercial' arrangements – arrangements that would not have been entered into between parties acting at arm's length. It is far from clear where this will lead as, after all, a family business is by definition a business carried on by people who are not at arm's length from each other.

A consultation paper, possibly with draft legislation, has been promised and once this is available we should be able to give clients at least an outline of how the new legislation is likely to affect them.

RECENT TAX CHANGES

The Finance Act 2007 has been criticised for being, in places, so broadly written that its application to particular circumstances is unclear, leaving the detail to be provided by Guidance Notes published by HM Revenue & Customs. One example is the legislation designed to stop people reducing their capital gains tax liabilities by manipulating loss relief claims. However, neither the legislation nor the Guidance Notes are entirely clear about the following, quite common, situation:

> Husband sells a block of shares (quoted on the Stock Exchange) in order to crystallise a loss which can be set against his other gains. His wife immediately buys an identical block of shares for her own portfolio.

In view of the doubt, we would, for the time being at least, advise against such transactions. However, there is no objection to other 'double bed-and-breakfast' transactions – for example where the husband sells a holding standing at a small gain, in order to utilise his annual exemption, and his wife immediately buys an identical block of shares for her own portfolio.

HMRC have also made it clear that it is still quite acceptable for one spouse to transfer an investment, standing at a loss, to the other, and for the recipient to sell that investment to crystallise the tax loss, which can then be set against gains on his or her other investments. (Under the usual capital gains tax rules, the transfer between husband and wife is effectively ignored and the transferee is deemed to have acquired the investment at the original cost to the transferor.) The reason for accepting this tax planning stratagem, but not the 'bed-and-breakfast', is not clear.

Loss relief for partners

Another anti-avoidance provision in the new Finance Act, although aimed at blocking aggressive tax planning, may also impact on family businesses. This is that a partner will not be able to claim 'sideways relief' (relief against other income) for losses in excess of £25,000 a year, unless he or she works for at least ten hours a week in the partnership business. A family which has a portfolio of businesses, for example, may find that a member who is a partner in a business which makes a loss for a year, does not work for the requisite ten hours a week in that particular business. Or it may be that the older generation contributes capital and expertise, but a limited amount of time, to the family business. Accordingly, it may be that business structures need to be re-examined.

Holiday homes abroad

It is very common for holiday homes abroad to be held through a company – sometimes because the country concerned does not permit non-nationals to buy local property in their own names; sometimes because the property was already held within a company and it was easier and cheaper to buy the company than the property itself; and sometimes to avoid local inheritance laws which restrict a testator's right to leave the property as he or she chooses.

On occasion over the last ten years or so, the Revenue have argued that the owners of such companies are its directors (and even if they are not named as directors, are 'shadow directors') and, as such, are subject to the usual rules for taxing directors' benefits-in-kind. In other words, it was claimed that an income tax and National Insurance contribution liability could arise on the 'benefit' a United Kingdom resident enjoyed by occupying his own holiday home abroad.

In his Budget last March, the Chancellor of the Exchequer announced that next year's Finance Bill (that is to say, the Finance Act 2008) will abolish any such tax charge, with retrospective effect. The year's delay appears to be to allow time for detailed consultation on the exact wording of the new legislation.

However, four possible problems remain. Firstly, the new legislation will apply only to overseas property – there is still, potentially, a tax charge on the occupation of property in the United Kingdom owned through a company.

Secondly, the new exemption applies only where the company's sole function is to hold the overseas property and to receive any rents from commercial lettings (whether holiday lettings or long-term leases). Any other business activities will disqualify the company. Moreover the company may own only one foreign property (though, paradoxically, an individual may own several companies, each owning an individual property).

Thirdly, a company will not qualify unless it is wholly owned by individuals. Thus a subsidiary company will not qualify. Furthermore, the company must not have been funded by an associated company – for example, by loans from the family's UK trading

company. The position of a property-holding company which is owned by a family trust is not yet clear.

Fourthly, the property-owning company will still be 'associated' with any other companies owned by the same shareholders (or their spouses), for example a family trading company. The significance of this is that the existence of the property-owning company may, in some circumstances, restrict the ability of the trading company to claim small companies relief, and so increase the corporation tax payable.

All in all, the Finance Act 2008 will not provide an answer to all the problems that may arise when a foreign holiday or retirement home is held through a company. If contemplating such a purchase, it is essential to obtain competent advice on the United Kingdom tax rules, as they apply to your own individual circumstances, and not focus exclusively on the overseas legal and tax implications.

Charitable donations

The two per cent reduction in the basic rate of tax, although announced as part of the Budget in March, will not take effect until April 2008. One effect will be to reduce the amount charities (including places of worship) may reclaim in respect of Gift Aid payments from their members and supporters.

For example, a £10 net donation currently grosses up to £12.82, creating a £2.82 tax repayment for the charity. From 6 April 2008, it will gross up to £12.50, reducing the tax repayment to £2.50 – a fall of over 11%. Supporters may wish to take this into account when timing their gifts (a donation on 5 April will be worth about 2.5% more than one made the following day, though strictly speaking gifts by cheque should clear by Friday, 4 April) and in setting their contributions for 2008/09.

Conversely, of course, the value of the higher rate relief to the donor, on the same £10 net donation, will rise from £2.31 to £2.50 (because the difference between the basic and the higher rate will be 20% instead of 18%). This again is something donors may wish to take into account when setting their contributions for 2008/09 – and something which charity treasurers and fundraisers may wish to point out to their supporters!

WATCH OUT FOR FRAUDSTERS!

There appears to be an outbreak of scams based on the fraudster pretending to be, of all people, HM Revenue & Customs. Contact is made by e-mail, telephone or ordinary post – in the latter case, often using official-looking forms. In some instances, there is a request or demand for outstanding taxes or for import duties said to be due on valuable goods held at the docks or airport. In others, there is a request for personal data, such as bank account details. Often, there is a statement that this information is required so that a tax repayment or a payment of Child Benefit, *etc*, can be made.

HMRC state that they never send unsolicited e-mails asking for personal information. Nor do they send e-mails which include links to pages which ask for personal information. Any such e-mail which purports to come from HMRC will therefore be fraudulent and should be reported by being forwarded to *domains@hmrc.gsi.gov.uk.*

Fraudulent forms received in the ordinary post can be harder to detect. If you are not sending the form to us to deal with, we strongly recommend that you check the return address against a reliable source, such as the telephone directory, or previous correspondence which you know to be genuine.

MAXIMISING STATUTORY MATERNITY PAY

It is not often realised that there are opportunities for maximising Statutory Maternity Pay (SMP), largely at the cost of the Government. Conversely, failing to consider the significance of some of the rules may lead to a substantial loss of benefit. In a family business context, this may be particularly important where a member of the family is herself about to become a mother, or the proprietors want to assist a valued member of staff at little cost to themselves.

For the first six weeks, SMP is paid at 90% of the employee's 'average weekly earnings' for the 'set period'. Broadly speaking, the 'set period' is defined as the eight weeks ending with her qualifying week, which is itself the fifteenth week before her baby is due – but the position is more complicated for monthly paid employees and a detailed explanation is outside the scope of these notes. It will in all cases be essential to ensure that the woman's 'set period' has been correctly ascertained.

Maximisation can then be achieved by noting that all earnings, subject to Class 1 National Insurance contributions, count towards the calculation of 'average weekly earnings' if they are *paid* in the 'set period', irrespective of the period to which they relate. Bonus, commission, backdated pay awards and similar items of remuneration can, accordingly, be brought into the SMP calculation by the simple expedient of ensuring they are paid during the 'set period'.

Most firms can reclaim 104.5% of the SMP paid from the Government (the additional 4.5% is a subsidy towards the National Insurance contributions paid on SMP); large employers can reclaim only 92%. In either case, almost the whole cost of increasing the employee's SMP falls on the Government.

This newsletter deals with a number of topics which, it is hoped, will be of general interest to clients. However, in the space available it is impossible to mention all the points which may be relevant in individual cases, so please contact us for personal advice on your own affairs.