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SPOUSAL REMUNERATION

Jones -v- Garnett (the "Arctic Systems" case)
HMRC issues more detailed guidance

Background

Readers will be familiar with the Arctic Systems case but, by way of summary, the case involved a situation where a private company had equal shareholders – being Mr and Mrs Jones. The company's income was predominantly generated by Mr Jones. Although Mr and Mrs Jones were equal shareholders in the company, with one share each, Mrs Jones spent only a little time on the affairs of the company. Only a small salary was paid to Mr and Mrs Jones which meant that a substantial part of the company's post-tax profits could be paid to them in the form of dividends. Many small owner-managed companies do, of course structure their financial affairs on a similar basis.

Under the settlements legislation, where somebody has made a gift (and subject to the satisfaction of certain conditions), income can be taxed as that of the donor rather than that of the recipient. The Arctic Systems case reached the House of Lords where the Law Lords decided that, because this involved an arrangement which included an element of bounty, there was a settlement for income tax purposes. However, because the income arose out of an outright gift from Mr Jones to Mrs Jones, this did not count as settlement income within the appropriate legislation. The consequences of the decision are that dividends paid to Mrs Jones should be taxed as her income and not as her husband's income as a settlor.

Very shortly after the decision, a ministerial statement was issued by the Government which included these passages:-

"The Government is committed to maintaining fairness in the tax system. The case has brought to light the need for the Government to ensure that there is greater clarity in the law regarding its position on the tax treatment of "income splitting".

"It is the Government's view that individuals involved in these arrangements should pay tax on what is, in substance, their own income and that the legislation should clearly provide for this.

The Government will therefore bring forward proposals for changes to legislation to ensure this is the case. In the meantime, HMRC will apply the law as elucidated by the House of Lords and will be providing guidance in due course".

Guidance

Shortly after the decision was handed down HMRC issued interim guidance on the application of the legislation in cases similar to Arctic Systems. At the time HMRC promised to issue further, more detailed, guidance which is now available in the HMRC Trusts Settlements and Estates Manual. In addition Helpsheet 270, which accompanies the Trusts self assessment return, has been revised.

Guidance in Appendix A to "A Guide to the Settlements Legislation for Small Business Advisers", which the Inland Revenue produced in November 2004, gave in one place 21 examples of business situations where the settlements legislation did apply and in another place 10 examples where it did not.

The new guidance adopts the same example format. However, the examples of when the legislation will apply and when the legislation doesn't apply are not in one place but mixed. For instance, example 8 is entitled "partnerships with a sleeping partner where the settlements legislation will not apply" and example 10 explains the circumstances in which this example will apply. In all there are 24 examples, not all related to businesses, and, as would be expected, some of them mirror examples in the November 2004 guidance. Example 6 – "outright gift not wholly or substantially a right to income" – reflects the decision in Arctic Systems and concludes as follows "The settlements legislation does not apply and we would not treat the dividends as income of X". Other examples cover such situations as shares with restricted rights, dividend waivers and subscribed shares.

COMMENT

Those who advise small businesses should study the revised guidance and Helpsheet 270 before establishing or reviewing structures designed to minimise the tax position of a husband and wife/civil partner who are both involved in a private business.

SALARY SACRIFICE OPPORTUNITIES IN 2008/09

The sharp rise in the upper earnings limit for 2008/09 will create new salary sacrifice opportunities

The upper earnings limit (UEL) for 2008/09 will be £770 a week (£40,040 a year) compared with the current limit of £670 a week (£34,840 a year).

The personal allowance for 2008/09 will be £5,435 and, while the basic rate band ceiling has not yet been confirmed, if it follows statutory indexation it will be £36,000 of taxable income, against a current £34,600. The gap between the UEL and starting point for higher rate tax for someone entitled only to a personal allowance could thus shrink to £1,395 in 2008/09 (£5,435 + £36,000 - £40,040) against £4,985 this year (£5,225 + £34,600 - £34,840).

This produces some odd effects for employees with taxable benefits, such as a company car and private medical insurance. If the taxable value of their benefits in 2008/09 is more than £1,395 they will find themselves in a position where they are paying higher rate tax *and* full rate NICs on part of their earnings. This opens up a bigger opportunity for salary sacrifice because the net income sacrificed will be that much lower. The example below shows what can happen.

In 2008/09 Bob earns £40,000 a year and has a company car with a taxable value of £3,000. He is contracted into S2P. His net personal allowances is £2,435 (£5,435 - £3,000), giving him a tax code of 243L. His income is subject to tax and NICs as follows:

Band of earned income	Tax	NICs
£0 - £2,435	0%	0%
£2,435 - £5,435	20% *	0%
£5,435 - £38,435	20% *	11%
£38,435 - £40,000	40%	11%

* Following the reduction of the basic rate of tax to 20% and abolition of the 10% starting rate for earned income and pensions from 6 April 2008.

Thus on his top £1,565 of income Bob will be paying 40% income tax plus 11% NICs – a total of 51%. If he sacrifices that £1,565 of gross salary in favour of an employer pension contribution, he will effectively get 51% total relief, even if his employer pockets all the NIC saving. If the employer chips in the employer NIC saving, the effective rate of relief rises to 56.6%.

In 2009/10 the UEL is due a further inflation-beating rise, in line with the announcement in the March Budget. The second hike will see the UEL equal to the 2009/10 personal allowance plus the 2009/10 basic rate band (which itself will be increased by £800 a year above indexation). The resultant UEL could be around £830 a week (£43,160) a year. This will create even more scope for the type of salary sacrifice described above. And in 2009/10 the introduction of the upper accrual point will mean there is a slice of earnings which could attract 11% NICs but no S2P accrual (or contracted out rebate), making salary sacrifice even more attractive.

COMMENT

Salary sacrifice for employees on the margins of higher rate tax will become more attractive next year.

WORK PLACE CONTRACT-BASED PENSIONS

A guide on the regulation of work place contract-based pensions has been produced

A guide on the regulation of work place contract-based pensions (ie. broadly GPPs) has been produced jointly by the FSA and the Pensions Regulator.

GPPs fall under the remit of both the FSA and the Pensions Regulator. Where there is a need for regulatory action in respect of a GPP the regulators will liaise and decide which one of them will take the lead.

Where the risks relate primarily to the employer (eg. non payment of contributions, or not passing on employee contributions to the GPP provider) the Pensions Regulator is more likely to take the lead, while risks which apply across the whole of a provider's GPP portfolio are more likely to be addressed by the FSA.

The guidance includes examples of when either regulator might intervene, as well as examples where neither will become involved. It also includes a useful appendix setting out the roles of the various bodies/participants in a GPP, and where either of the regulators may seek to take action.

INCOME TAX

Because the value of the September Retail Prices Index was not available when the Pre-Budget Report was presented on 9 October, it was not possible to give details of the personal allowances for 2008/09 in money terms at that time. The main personal allowances applicable for tax year 2008/09 have now been announced and are as shown in the table below.

	2007/08	2008/09
	£	£
Personal allowance – standard	5,225	5,435
- Age 65 – 74	7,550	9,030
- Age 75 and over	7,690	9,180
Married couple's allowance (MCA) – minimum amount	2,440 (B)	2,540 (B)
- Age 65 - 74	6,285 (C)	6,535 (C)
- Age 75 and over	6,365 (A)	6,625 (A)
Age-related allowances reduced if total income exceeds (D)	20,900	21,800
Maintenance to former spouse for all orders provided one party was	2,440 (A)	2,540 (A)

65 or over before 6 April 2000		
Employment termination lump sum limit	30,000	30,000

(A) Relief at 10%.

(B) Minimum amount of MCA for age allowance purposes only.

(C) Relief available at 10% only if at least one of the couple was aged 65 before 6 April 2000.

(D) For 2008/09 the reduction is £1 for every £2 additional income over £21,800 [£20,900 for 2007/08]. Standard allowance(s) **only** are available if total income exceeds:-

	2007/08	2008/09
	£	£
Taxpayer aged 65 - 74 [personal allowance]	25,550	28,990
Taxpayer aged 65 - 74 [married couple's allowance]	33,240	37,280
Taxpayer aged 75 and over [personal allowance]	25,830	29,290
Taxpayer aged 75 and over [married couple's allowance]	33,680	37,460

LIFE COMPANIES AND INVESTMENT LINKS

There has been a change to the rules on what investment links a life company can offer

Until recently, the rules governing investments that were eligible for UK life assurance linked funds had been in place virtually unchanged since 1994. As a result they had become rather outdated. For example, under the old 'permitted links' rules, a life company could offer a linked fund that invested directly in commercial property but could not, without an FSA waiver, invest in property via a collective fund. The rules allowed for no exceptions, with the result that FSA waivers were often requested for what would have been minor infringements.

In March 2007 the FSA issued a consultation paper proposing an overhaul of the permitted links regime. A policy statement was issued in September and the bulk of the new regime came into effect in early October. With the arrival of the MiFID on 1 November, the final elements were put in place.

The new regime is based on high level principles rather than the restrictive definitions of the old rules. For example, the old requirement that, outside land and property, assets had to be 'readily realisable', has been replaced with a rule that an insurer's linked assets 'are capable of being realised in time for it to meet its obligations to linked policyholders'. In a similar vein, an insurer 'must consider the economic effect of its permitted links and linked assets ahead of their legal form'.

The new rules can be summarised briefly as:

- Any collective investment scheme (CIS) that is authorised for retail distribution in the UK by the FSA automatically qualifies as a permitted link. Similarly, a retail UCITS fund authorised outside the UK qualifies as a permitted link if it has exercised MiFID 'passporting' rights. Other retail overseas funds recognised by the FSA (eg some Jersey funds) also qualify.

- Investment in property can be in any market regarded by the insurer as 'properly functioning'. Under the old rules there was a specific geographical list.

- Property funds can invest via unauthorised property CISs, but total holdings must not exceed 20% of assets.

- Minor rule breaches, eg because of suspension of individual assets, are reportable, but no longer require a specific FSA waiver.

In theory the new regime makes it easier for UK life companies to add new life and pension linked funds. In practice, there may be a reluctance to do so, at least on the life side, until the current debate with the Treasury about life company tax on capital gains is concluded.

COMMENT

This is a welcome tidying up and will remove the issues that some insurers had with links to retail CISs.

DORMANT BANK AND BUILDING SOCIETY ACCOUNTS

The Dormant Bank and Building Society Accounts Bill recently received its first reading in House of Lords.

This Bill will allow money lying dormant in banks and building society accounts to be reinvested in the community. In the Bill a dormant bank/building society account is defined as one where there has been no customer-initiated activity for 15 years.

As part of the scheme, the industry will strive to reunite account holders with their lost accounts. If the account holder cannot be found, the money will be transferred to an FSA authorised reclaim fund, which will hold the money should people later come forward to reclaim their accounts. Money held in the fund can then be used to pay account holders their money with interest owed. Sufficient reserves would be kept back to meet anticipated levels of claims for repayments and expenses, and the surplus money will be reinvested in the community via the Big Lottery Fund on a national basis.

THE NATIONAL INSURANCE CONTRIBUTIONS BILL

The Government has introduced the National Insurance Contributions Bill to implement the changes to the accrual of S2P benefits and the payment of NI contributions that were set out in the 2007 Pre-Budget Report (PBR).

In the 2007 Budget the Government announced that from April 2009 the Upper Earnings Limit (UEL) will be aligned with the starting point for the higher rate tax band (allowing for the personal allowance). In isolation this change would have created extra costs to the

Exchequer as a result of increased S2P accrual and higher NI contracting out rebates. To combat this the Government announced in the PBR that, for the calculation of S2P benefits and the corresponding rebates, from 6 April 2009 the UEL will be replaced by the Upper Accrual Point (UAP). The original Pensions White Paper had envisaged this switch over taking place from April 2012, with the UAP matching the then UEL.

The National Insurance Contributions Bill makes provision for the PBR change and indicates that the UAP will be set at £770 per week (ie. the same level as the UEL for 2008/09). While the UEL will, after the special increases applied in tax years 2008/09 and 2009/10, once again be increased each year broadly in line with changes in the RPI, the UAP will remain fixed at the £770 level. The Bill also confirms that with effect from tax year 2009/10 the S2P benefits accruing on the band of earnings up to the Low Earnings Threshold (ie. £13,000 in today's terms) will be a weekly flat rate amount. These changes form part of the Government's plan to move S2P benefits onto a purely flat rate basis, which is now projected to occur in 2031/32.

The introduction of the UAP will also mean that from tax year 2009/10 NI contracting out rebates will be based on earnings up to the UAP, rather than the UEL. The UEL will continue to act as the limit for full employee NI contributions (with the 1% NI contribution level continuing to apply on earnings above the UEL).

The above will mean, for example, that where an individual has earnings in excess of the UEL, and is contracted out under a final salary scheme his NI contributions from tax year 2009/10 onwards will be as follows:-

0% on earnings up to the Lower Earnings Limit (LEL)
1.6% (rebate) on earnings between the LEL and the Primary Threshold (PT)
9.4% on earnings between the PT and UAP
11% on earnings between the UAP and UEL, and
1% on earnings above the UEL.

The UAP changes, alongside those in the Pensions Act 2007, will amend the accrual of S2P benefits as set out in the table below.

S2P Accrual

Earnings	**2002/03 – 2008/09**	**2009/10**	**2010/11 onwards** (see Note 3)
LEL –LET (see Note 1)	40%	Weekly flat rate	Weekly flat rate
LET – UET (See Note 2)	10%	10%	10%
UET – UEL	20%	N/A	N/A
UET – UAP	N/A	20%	10%

Notes:

1. The weekly flat rate amount is £72.80 a year (£1.40 a week) in 2005/06 terms, revalued in line with earnings for each year of S2P membership from 2009/10.

2. UET = Upper Earnings Threshold (ie. £30,000 in 2007/08 terms).

3. The flat rate weekly accrual will be introduced from tax year 2009/10 while from 2010/11 onwards earnings between the LET and the UAP will only benefit from a 10%, rather than 20%, accrual rate. By around 2031/32 S2P will become a totally flat rate benefit.

NON-UK DOMICILIARIES

Capital gains and non-UK domiciliaries – proposed changes

At the time of the 2007 Pre-Budget Report, the Government announced that it would be introducing changes to combat some of the various devices that exist to enable non-UK domiciliaries to bring back overseas income/gains to the UK yet avoid a remittance tax charge. They described these measures as *"reducing the scope for the alienation of income and gains through the use of offshore structures, such as companies and trusts, which convert taxable income and gains into non-taxable payments."*

Under current legislation, in cases where an offshore trust has been created by a non-UK domiciled settlor then, provided the settlor continues to be non-UK domiciled, for CGT purposes any capital gains of the trust will count as "trust gains". No immediate CGT liability will arise but those trust gains will be attributed to capital payments made to a beneficiary who is then both UK resident and domiciled and will be charged to capital gains tax. A supplementary charge can then arise at 10% pa of the tax due for each year from when the gains were realised to the date payment was made but capped at a maximum of 6 years. Should the trust come to the end of the trust period, the outstanding trust gains at that time will be attributed to the beneficiaries who then become absolutely entitled to the trust capital.

Thus such trusts currently offer the scope for tax deferral with the possibility of complete CGT avoidance if the capital of the trust is eventually paid to a non-UK resident beneficiary. Indeed, currently, UK residents who are non-UK domiciled can use an offshore trust to provide effective CGT deferral on both UK **and** overseas investments. As part of the consultative process, details of some of the proposed changes to combat these devices are now emerging and the extent of the changes is causing widespread concern amongst professional advisers.

It would seem that the proposed anti-avoidance measures will distinguish the tax position between cases where an offshore trust owns UK-based investments and offshore investments. This is likely to mean that there will be immediate taxation where an offshore trust realises UK-based investments whereas there will still be some element of deferral on non-UK based investments.

This is a radical change from the current regime in which wealthy individuals can use offshore trusts to defer (and possibly avoid) tax on the sale of UK assets and rarely pay any capital gains tax on the capital they bring into the country provided they can ensure that its source is pure capital and not gains or income.

Draft legislation is due to be "published" this December.