

## How much may contractors pay their spouses? arctic systems will decide

Does your spouse work with you? How much can you pay your spouse, and can you continue to [share dividends](#) from your [limited company](#) with your spouse?

### Test Case Before the Lords

HM Revenue has some specific ideas about this, and they are being tested in court this week. The Jones v Garnett case, also known as The 'Arctic Systems' case after the name of the IT consulting company in question, is being heard by the House of Lords from June 5-7. It will help to decide how contractors may share income with spouses who work with them.

ContractorCalculator has [already predicted](#) that the Lords will support the view of the Court of Appeals that the Revenue is wrong, and will reject HMRC's appeal. A ruling is not expected before the end of the summer, however.

The issues in the case are complex: it all stems from what the lawyers call "settlements law," as [Andrew Webster](#), of the Cambridge-based law firm Andrew Webster Limited explains (the specific legislation is [Section 660A](#) in the tax code and was introduced in the 1930's).

### Whose Income Is It?

Suppose you have money invested that brings in an income of GBP 100,000 per year. Your wife has no income. So to save money on income tax, you pass 50,000 over to your wife, and you both pay far less in taxes. The Revenue will have good reason to claim that you are simply avoiding paying the full amount, and will act accordingly to penalise you for this 'bounteous' distribution (the word 'bounteous' is the key word for when you do this the wrong way).

But suppose you are an IT contractor, and your spouse handles the administration and the books for your business. There are literally thousands of contractors who do business this way, and they routinely pay the spouse the minimum wage, and then share dividends from the company with their spouses.

### Is This 'Bounteous'?

The Revenue claims that the IT contractor at Arctic Systems does all the work, and that the spouse was simply working far less while receiving 'bounteous' payments for tax reduction purposes. A successful challenge by HMRC would lead to the dividends that had been paid to Mrs Jones being reallocated and taxed on Mr Jones, resulting in further tax being due and interest being charged on the underpaid tax.

Those of us who work in family businesses may not care much for the Revenue's definition of this dividend-sharing as 'bounteous.' Says Webster: "The Revenue are basing their case on the respective roles played by the husband and wife in the business. That is not necessarily easy to define. I think that the Revenue is applying this legislation in a way that it was not originally intended."

“ The Revenue is applying this legislation in a way it was not originally intended to be used ”  
Andrew Webster - Andrew Webster Limited

### What the Law was intended for

As the Bridport-based FCA [Nichola Ross Martin](#) explains, the first modern use of the law in this way was in Stott & Ingham v Trehearne [1924]. Here a father who was a partner in a partnership increased commissions payable to his sons as wages. Both sons made valuable contributions to the partnership but the special commissioners decided that 10% commission instead of 33% was more on a "commercial footing" and so 23% was disallowed as 'bounteous.'

"The commercial reality of this situation was that the father was simply diverting his partnership profit share to his sons," Ross Martin points out.

If you compare the Arctic Systems case with that of the 1924 example, the differences seem flagrant to many observers, among them notably Lord Justice Carnwath of the Appeals Court that rejected the Revenue's position in 2005. Lord Justice Carnwath said: "The Revenue's position in this case seems to me a significant extension. For the first time, they seek to apply the concept to what has been found to be a normal commercial transaction between two adults, to which each is making a substantial commercial contribution..."

The London-based contractors trade association [Professional Contractors Group](#) shares this view, and the organisation has helped to support Arctic Systems in its long battle against the Revenue. Says John Kell, PCG policy spokesman: "PCG's position is that HMRC is wholly wrong, both morally and in law, to attack family businesses through the settlements legislation and especially where retrospective tax is sought."

Many of the lawyers interviewed agreed that the Revenue is not likely to win this one. Contractors in this country can only hope that is indeed how it will turn out.

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“ HMRC is wholly wrong both morally and in law ”

John Kell - PCG

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