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Section 660a - minimising an inspection and potential penalties

Introduction

If you are new to contracting you will need to decide on a payment structure to charge for your contracting services. This will either be a limited company or an umbrella solution. If you choose a limited company option you will need to be aware of some tax legislation commonly known as Section 660A.

Put simply, HMRC are attempting to destroy the very long standing arrangement in small family businesses, whereby the shareholding would be split between spouses and other related parties, with a view to reducing income tax and national insurance liabilities, largely through the payment of dividends.

A great deal has already been written about the history of Section 660, the Arctic Case, the Appeal and technical arguments.

This article concentrates on the situation "as it is" and what you might do to minimise the chances of an investigation and potential exposure to tax liabilities and penalties.

Are you caught by Section 660A?

Section 660a only affects you if your spouse or other related third party owns shares in your company. If you are a "one person" company owning all the shares then it does not affect you.

However, if your spouse or other connected party has a substantial shareholding in your company but carries out very limited work for the company to generate fees then you are exactly the person that HMRC have in their sights with their Section 660a arguments. In this case you should consider the following possibilities to minimise your liability to an investigation:

Minimising the chances of investigation

Increase your salary to "market rate".

The High Court judgement in the Arctic Case mentioned the concept of a market rate for directors and employees. However, little guidance was given to exactly what a "market salary" should be.

HMRC are likely to consider any director's salary of less than £10k p.a. to be "blatant tax avoidance", particularly where the director is the only fee earner in the company and generates fees of five or more times that rate.

Taking a higher salary will attract both employees and employers national insurance but will reduce the chance of a Section 660a investigation, since HMRC would presumably rather spend their limited resources on pursuing more obvious cases.

Justify the related parties income.

HMRC's case will be significantly weakened if you can justify that the related parties income is based on actual work carried out

You should fully document the services carried out by them, which might include company administration like invoicing, banking, research, etc. All such functions are valuable services to the company and can be used to justify a "going market rate."

Justifying substantial dividends may be a little harder but when setting up a limited company, it would help if the third party could make a monetary introduction into the company as share capital to demonstrate an investment risk taken by them.

Such an "investment" would make HMRC's argument a little more difficult, compared with the case of a £2 company, into which no investment has been made. The investment would make it less likely to be pursued when there are so many "easy meat" cases available to an Inspector of Taxes.

Consider a partnership rather than a limited company.

If you do not obtain your work through agencies (which will insist on a limited company arrangement), you could consider switching your business arrangements to that of a partnership rather than a limited company.

HMRC's own internal manuals state that "it is worth emphasising that a partnership is not a sham, merely because it is set up to save tax".

The potential liabilities accepted by any partner under partnership law does make a Section 660a argument rather more difficult for HMRC in the case of partnerships.

That is not to say that trading as a partnership will act as a shield to Section 660 in all circumstances but it does reduce your chances of being selected for detailed investigation.

Transfer the shares of the spouse.

A transfer of the shares to yourself as the main fee earner will avoid future Section 660a problems.

HMRC can go back six years however, so such action does not make a potential problem disappear. However, the chances of being pursued for a situation which existed in the past is somewhat remote, particularly as HMRC are most likely to concentrate their fire power on those companies which are likely to yield the most tax and have the weakest argument to defend their position.

An alternative to transferring your shares would be to close down the limited company and start a new one, with yourself as sole shareholder. Again, this does not make the problems of the old company disappear but does reduce the probability of a problem.

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