

## Contractors who work with spouses need to understand arctic systems

The [Arctic Systems case](#), which the Revenue definitively lost on July 25, does have an effect on how contractors run their [limited companies](#). Contractors who work as husband-and-wife teams ignore it at their peril.

Many contractors have family businesses in which their spouses participate. It's logical to share income from the business then with spouses, and giving shares to them is a natural way to go about it. If you issue 100 shares of your business, perhaps you give your spouse 50 and you keep fifty. You can split them up in any way you like, but in general contractors [split dividends to maximise net income](#).

You probably earn a small salary from your business, and then pay yourself [dividends](#). As a shareowner, your spouse also would receive dividends. How the dividends are divided up depends on the kind of shares your company has issued: there are ordinary shares, preference shares, Class A and Class B shares – it all depends on the agreements you've made with shareholders and the way your company's Memorandum of Association stipulates division of profits

But there are limits to the ways in which you divide up your company's income from the Revenue's point of view. You can't give half your company's income in dividends to your 11-year old son. The Revenue will then point out that you are cutting your own income in half yet you are still reaping the benefits of that income. This is called a "bounteous" distribution.

And this is what poor East Sussex –based IT consultant Geoff Jones was accused of when he gave a large part of the income from his company Arctic Systems in the form of dividends to his wife Diana. Six years ago the Revenue cited Section 6 of the Code and told Jones that he was "bounteously" distributing money to his spouse in order to cut his own taxes. HMRC then presented Jones with a bill for GBP 42,000.

The House of Lords has definitively decided that the Revenue was wrong. "But not under all possible conditions," says [Keith Gordon](#), the barrister of the London-based [Atlas Chambers](#) who assisted barrister Malcolm Gammie QC in the Appeals hearings.

"It is true that the House of Lords has now put beyond doubt how independent taxation applies to family-owned businesses. In particular, they have held that the principles of taxation apply to income from family businesses in the same way as they apply to any other family income."

But contractors should note two aspects of the Lawlords' ruling [See [Arctic Systems judgement](#)]. Gordon explains:

The Lords of Appeal have stated that the income given to Diana Jones was a "bounteous distribution" because it is regarded as a gift.

However, because Diana Jones owned ordinary shares in Arctic Systems, a special exemption applied.

Diana Jones owned ordinary shares in Arctic Systems. Says Gordon: "Husbands can give income to their wives (or wives to their husbands) and that income becomes part of the wife's individual income provided that the gift comes without strings attached."

But more importantly, when contractors divide shares up amongst their family members, they should ensure that these are ordinary shares.

"There was a case about 11 years ago called Young vs. Pearce," Gordon points out, "in which a husband gave the wife preference shares and then sought to divide income from the company between them for tax purposes. The Lords ruled that this gift was merely a gift of income, and could not be handled in this way."

So it is essential that contractors seek advice if they intend to create more complex shareholdings in their limited companies other than the most basic division of a given number of ordinary shares to other family members.

Also important to note: this "let-out" as the lawyers refer to it is only available to legally married spouses. Don't try it with your live-in lover, or any other person who in some way shares the benefits of your company's income with you.

### Editors note (Feb 2012):

The original settlements legislation dates back to the 1930s and was subsequently updated first in 1988, when it became the more familiar Section 660. It was changed again in 2005 when it was updated and rewritten into its current form as Section 624 of the Income Tax (Trading and Other Income) Act (ITTOIA) 2005. See more information on the current [settlements legislation](#).

Published: Thursday, July 26, 2007

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Keith Gordon - Atlas Chambers



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