

**P**icture the scene: Tim Robbins's character in *The Shawshank Redemption*, Andy Dufresne, is on the rooftop when he overhears the prison guard talking about a big tax problem he has, arising from a recent gift. Dufresne asks him: 'Do you trust your wife?' Now in Shawshank prison, a prisoner's life was cheap and the guard must have thought that Dufresne was asking him did he trust his wife in the biblical sense, as he grabbed him and was about to throw him off the rooftop! Then in a moment of truth, shivering with fear, Dufresne tells the guard that if he did trust his wife and was willing to gift the money to her, he could legally avoid tax on the income from it. The prisoner added value that day in 1950s America by explaining the

benefits of income splitting, and indeed earned some nice cold beers for himself and his mates in the process! In the UK in 2010, nothing has changed since 1950s America: tax advisers can still add value by advising on the merits of income splitting – in fact with the advent of the new 50% income tax rate, it is potentially more relevant now than ever before.

Since they first drafted this article, the authors have had the benefit of reading Andrew Gotch's excellent piece on income shifting in the February issue of *Tax Adviser* (p27). Of necessity, what follows covers some of the same ground, but also considers the benefits of income splitting with a company.

First, let us recap on the tax changes that have made income splitting more

relevant than ever as a tool in the tax adviser's armoury. From 6 April 2010 the following changes will be introduced to income tax rates:

- a new 50% rate of income tax will apply to taxable income above £150,000. The 20% rate will continue to apply to income up to £37,400, and the existing higher rate of 40% will apply to taxable income between £37,400 and £150,000;
- the basic personal allowance for income tax (£6,475 for tax year 2009/2010) will be withdrawn for individuals earning more than £100,000, on a phased basis so that there will be a £1 reduction in allowance for every £2 of income earned above this level. This will mean that there will be no personal



Do you  
trust  
your  
wife?

*Patrick Harney and Alexandra Davies* respond to the tax changes that have made income splitting more relevant than ever

## Example 1

*Income splitting with a spouse (direct ownership of assets)*

Mr X has investment income of £200,000 for the tax year 2010/2011. Mr X will be taxed as follows:

@ 20% on income up to £37,400

@ 40% on income up to £150,000

@ 50% on the remainder of his income

In addition, Mr X's personal allowance is reduced to zero.

The total income tax liability for Mr X will be £77,520.

*Income tax liability if income is 'split'*

If Mr X's income is 'split' with Mrs X, their income tax liability will be as follows:

Both Mr and Mrs X will benefit from the full personal allowance of £6,475. Therefore they will each have taxable income of £93,525 and pay tax on it as follows:

@ 20% on income up to £37,400

@ 40% on the remainder of their income

Mr and Mrs X each pay tax of £29,930. The overall saving is £17,660.

## Example 2

The following is an adapted example from practice. The original motivation for the planning undertaken was not income splitting, but a desire to separate control and ownership of the target investment company for estate-planning purposes.

A £5m rental investment property is to be acquired by a family partnership, the partners of which are the father (a widower) and his four minor children. Since the children are minors, all of the partnership's income is assessed on the father, who is already a higher-rate taxpayer by virtue of his employment income.

Assuming that the property has a rental yield of 5% net of expenses, there will be annual taxable rental income of £250,000.

From 6 April 2010, the father's income tax liability at the 50% rate will be £125,000.

If, instead, the property is owned through a company, which the father controls – with, for estate planning reasons, most of the ownership of the shares that carry dividend rights and rights to participate in a winding up, in the children's hands – the effect is that the tax rate on the rental income (up to £300,000) is reduced from 50% to 21%.<sup>1</sup> This reduces the annual tax liability to £52,500, resulting in an annual tax saving of £72,500. If dividends were paid to the children during their minority to cover school fees or other maintenance, they would be assessable on the father under *ITTOIA* 2005, s. 629 at the new 42.5% dividend rate (effective rate of 36.1% net of the tax credit). However, the father plans to maintain the children during their minority from his after-tax employment income and to use his control of the company to make dividend payments to them after they turn 18 to fund their university educations. Subject to the *ITTOIA* s.631 risk discussed below and based on the 2009/10 basic rate band, the children can each, after they turn 18, receive annual dividend income of up to £37,400 without a tax liability, as the 10% tax credit entirely franks their tax liability on that level of income.

*ITTOIA* s. 631 provides that where the trustees of a settlement retain or accumulate income and a payment is subsequently made in connection with the settlement to an unmarried (or not in a civil partnership) child of the settlor, then the payment is treated as income of the settlor. If s. 631 applied to the above arrangement, then the dividend income paid to an adult unmarried child would be assessable on the father. The father may be able to take the following view: the 'settlement' for the purposes of *ITTOIA* s. 629 and s.631 is not the purchase of the investment property through the company but rather is the gift of the shares in the company. Since no dividends were declared on those shares, during the child's minority there was no 'income' that was capable of being retained, and hence s. 631 has no application.

Another possibility with a company is to split *dividend* income. This should avoid the potential double tax charge mentioned above, because UK and most foreign dividends a company receives will be exempt from corporation tax. However, specific advice should be taken if either of these options is considered appropriate. A full discussion on family investment companies is beyond the scope of this article; for more information see 'Family Investment Companies – a viable alternative vehicle to trusts?' by Patrick Harney and Angus-Hunter-Smart (*Elderly Client Adviser*, September 2009).

allowances for incomes over £112,950 (based on the 2009/2010 personal allowance).

These measures highlight the increasing differential between income and capital gains tax rates, currently up to 32% for 50% rate taxpayers. As a result, there has been increasing emphasis on tax-planning strategies to capitalise income. However, with the likelihood that the new coalition government will increase capital gains tax to 40% (or even 50% for 50% taxpayers), another less aggressive planning device that is now likely to be relied on is income splitting: a means by which a taxpayer can arrange his affairs so that income is diverted from his own higher rate band to a second person's basic rate band.

## Advantages of income splitting

The advantages of income splitting are best illustrated by an example, for the purposes of which we have assumed that Mr and Mrs X are both UK resident and domiciled and under 65. We have also assumed that Mrs X is a lower-rate taxpayer with no significant income source of her own.

*See example 1 above left.*

## Income splitting with a limited company

Spouse or civil partner income splitting has its limits since, even when the legal barriers to it can be overcome, there is a limit to the amount of tax that can be saved and it is of necessity dependent on the high earner having a spouse or civil partner and on that spouse or civil partner having little or no income of his/her own. Income splitting with a company, by contrast, is not limited to a specific set of facts and is not limited to a maximum amount of income that can enjoy the 28% corporation tax rate. It allows the company's share of the income (up to a maximum of £300,000) to be taxed at the 21% small companies' rate of corporation tax or 28% if the company is classed as a 'close investment company' or has profits in excess of £300,000, rather than the new 50% income tax rate from 6 April 2010.

However, this technique will only be helpful where the taxpayer is happy for income to be accumulated

in the long-term. Where the taxpayer wishes to extract income from the company on a regular or semi-regular basis and the underlying profit is non-dividend income or capital gains, this type of planning will not be appropriate. This is because of the double tax charge when dividends are paid out: corporation tax of 21% (or 28%) on the profits of the company, representing non-dividend income and/or capital gains, and income tax on the dividend income at the taxpayer's marginal dividend rate.

See example 2, previous page.

### Legal barriers to income splitting – the settlement code

Where planning is undertaken with the aim of splitting income, the taxpayer needs to ensure that the arrangements do not fall foul of the settlement code<sup>2</sup>. Where that code applies, all of the income will be treated as the settlor's, thus negating the benefits of splitting the income.

The settlement code targets income splitting arrangements through reliance on four rules, which attribute income to the settlor where:

- (i) income arises on property in which the settlor has an interest;
- (ii) income is paid or applied for the benefit of a relevant child (a child [including a step-child] who is under 18 and not married or in a civil partnership);
- (iii) income arises to the settlor when capital sums (including loans) are paid to the settlor by the trustees of a settlement; and
- (iv) income arises to the settlor by a body corporate connected with the settlement.

For the purposes of the settlement code, a 'settlement' is widely defined and is deemed to include any disposition, trust, covenant, agreement, arrangement or transfer of assets. It is therefore capable of catching not only trusts but other arrangements, schemes and contracts that are entered into for the purpose of income splitting. The 'settlor' for these purposes is the person making the settlement.

### Current law on income splitting – Arctic Systems

The seminal case in relation to income splitting between spouses is *Jones v*

It may be wise to explore the possibilities that income splitting offers as long as they are available

*Garnett [2007] STC 1536*, also known as the Arctic Systems case. It illustrates a situation that successfully precluded the settlement code from applying.

The taxpayer decided to set up in business as an information technology consultant. He formed a company with an issued share capital of £2, which offered his consulting services, and he and his wife took one share each. The husband was the sole director and his wife agreed to handle all of the company's financial and administrative requirements. They each received small salaries and substantial dividends from the company. HMRC assessed the husband on the dividends his wife received on the grounds that the arrangements constituted a settlement of which he was the settlor.

The House of Lords unanimously held that the arrangement constituted a settlement. However, the husband's transfer of his shares to his wife was an outright gift and consequently fell within the outright gift to spouse or civil partner exemption<sup>3</sup> on the basis that the gift was not substantially a right to income but a genuine redistribution of capital.

### Possible income-splitting legislation

The existence of the exemption concerning outright gifts between spouses, combined with the House of Lords' decision in Arctic Systems, means that income splitting, where planned and implemented appropriately, remains an attractive option for married couples.

Following the Arctic Systems case, the previous government announced its intention to legislate to reverse the effect of the decision, and this was reiterated in the 2007 pre-Budget report. However, in the 2008 PBR, it stated that 'given the current economic challenges' they would not be bringing forward such legislation in *Finance Act 2009*, but would instead keep the issue under review. Therefore, although we do not know how much longer income splitting will remain possible, it may be wise to explore the possibilities as long as it does.

It will also be interesting to see whether the new coalition government takes forward the proposed income splitting legislation. However, the authors concur with Andrew Gotch's view that there is no need for income-splitting legislation in view of the very wide scope of the existing legislation. This is particularly so in relation to the very wide wording in the exception to the outright gift between spouses or civil partners exemption in *ITTOIA* s. 626(4)(b).

### Conclusions

The 50% income tax rate compared to the current 21%/28% corporation tax rate means that holding some or all of an individual's income-producing assets through a limited company is going to have an increasing role to play in future tax planning. It also creates significant flexibility for separating control and ownership for estate planning purposes, which is of increasing relevance in the light of the *FA 2006* clampdown on trusts.

With the increasing tax burden on higher-rate taxpayers, income splitting is worth exploring where there is a spouse with no significant income of his or her own, but needs to be planned carefully so as to come within the *ITTOIA* s. 626 exemption. The client just needs to be able to 'trust his wife' (or husband or civil partner as the case may be), and then his friendly tax adviser can perhaps enjoy those beers in the sun!

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1. If the sole asset of the company is an investment property let to unconnected persons, then it should fall outside the 'close investment companies' rules in *ICTA* s. 13A, and so the 21% corporation rate should be available on the first £300,000 of profits.
2. *ITTOIA 2005*, part 5 chapter 5
3. *ITTOIA 2005*, s. 626