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Dividend diversion scheme does not work

Synopsis: HMRC has warned that a school fees tax avoidance scheme does not work, warning promoters that they must disclose a scheme within five days of it being available.

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The scheme diverts dividend income from a company owned and managed by the parents into a trust for their children, which then pays the school fees for those children. The arrangements seek to avoid tax by allowing the directors, who are also the main shareholders (the owners) of the company, to divert dividend income from themselves to their minor children.

Normally, the parents would be taxed on this income if they directly paid dividends into a trust for their children. However, a relative or friend of the parents subscribes for B shares in the parent's company, which have a right to receive a special dividend. That friend or relative then declares a trust of those shares in favour of the children, and that dividend income is treated as belonging to the children.

The scheme relies on the parents being higher or additional rate taxpayers, who have already used their dividend and personal allowances. The children will be basic rate taxpayers who can also set their full personal allowance and dividend allowance against the dividend income.

HMRC has issued Spotlight 62: Dividend diversion scheme used to fund education fees, describing the following six-point structure of the scheme…

- a company issues a new class of shares which usually entitles the owner of the shares to certain dividend and voting rights;
- Person A, usually a grandparent or sibling of the company owner, purchases the new shares for an amount significantly below market value;
- Person A usually gifts the shares to a trust or declares a trust over the shares for the benefit of the company owner's children;
- Person A or the company owners vote for substantial dividend payments in respect of the new class of share;
- this dividend payment is paid to the trustees of the trust;
- as the beneficiaries of the trust, the company owner's children are entitled to the dividend.

The company owner's children pay tax on the dividend received. However, they pay much less tax than if the company owners received the dividend due to their children's…

- £12,570 tax-free personal allowance;
- £1,000 dividend allowances;
- eligibility to the dividend basic tax rate.

HMRC's view is that this scheme does not work as the arrangements are caught by specific anti-avoidance legislation contained in Income Tax (Trading and Other

Income) Act 2005, from S619 onwards that prevents this type of arrangement providing the tax advantage that is sought. HMRC says that arrangements which operate in a similar way may also be caught by this legislation.

HMRC has warned promoters in Spotlight 62 about their obligations under the disclosure of tax avoidance schemes (DOTAS) rules.

This legislation requires a scheme to be disclosed where the following apply…

- it has one or more defined “hallmarks”;
- it is expected to provide a tax advantage;
- that advantage is one of the main benefits for the users of the scheme.

The key point of the school fees scheme is to take advantage of the children’s lower tax rate and personal allowances to set against income that would otherwise be taxed in their parents’ hands, so there is a tax advantage, and that advantage is why the scheme is used.

Hallmark 9: financial products is the one relevant to the school fees scheme. The B shares issued by the parents’ company, which are put into trust for the children, are the financial product.

Where a firm has promoted this scheme they need to disclose that fact to HMRC using form AAG1. It is irrelevant whether the firm has successfully sold the scheme to a client, where it has been promoted it must be disclosed to HMRC.

This disclosure should be made within five days of the scheme being made available or implemented. There are limited exceptions to this requirement, such as where there is no external promoter, or the promoter is not in the UK.

If a client has taken up the scheme, the promoter needs to provide that client with a DOTAS scheme reference number (SRN) on form AAG6. HMRC issue the SRN to the promoter when the form AAG1 has been filed. Form AAG6 makes it quite clear to the taxpayer that a tax avoidance scheme has been used and HMRC has not approved the scheme.

The taxpayer who has used the scheme must declare the SRN on their tax return for the periods for which the tax advantage is gained from using the scheme.

Where the promoter fails to disclose the scheme to HMRC within five days, they can be hit with an initial penalty of up to £600 per day, for every day of delay. If HMRC feels that the daily penalty is not enough to discourage the promoter from selling the scheme it can levy a penalty of up to £1m.

Where an abusive tax avoidance scheme has been shown to fail, HMRC has another penalty up its sleeve for enablers of defeated tax avoidance schemes. This penalty is equal to the total fees the promoter has earned from selling the tax avoidance scheme.

It is also possible that any school found to be facilitating the structure could well be an enabling participant, potentially liable for a penalty equal to 100% of the fees received from the structure.

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