Think Ahead ACCA

Technical factsheet

Shares owned by children: legal and tax implications

Introduction

Many business owners consider giving their children shares and then paying dividends on those shares, looking to take advantage of the children's personal tax allowances. Particularly among small family-owned companies, shares may be allotted to children as part of long-term inheritance tax planning, providing them with shares which will hopefully rise in value over time. In many such cases, different classes of shares are set up so that the child may, for example, have non-voting shares, or so that the directors can pay different rates of dividends on the various classes, giving flexibility as to how the company's profits are distributed. But the law is very strict in this area, and income from shares transferred from a parent to their child will usually still be taxed on the parent.

This factsheet will look at the legal and tax implications of a child owning shares, and other circumstances in which 'settlement' legislation will apply.

Can shares be legally held by children?

Provided the articles of association do not impose any restrictions on the age of the shareholders, there is no statutory provision prohibiting a child from owning shares.

Public companies often provide that a minor may not hold their shares. Such shares are often held by parents or grandparents etc as trustees for children, or alternatively some form of investment trust is used.

Some banks or other providers require all shareholders to consent before a contract is entered into. If a child, who lacks capacity to contract, holds a proportion of the shares then it may be difficult for the company to access such services.

This is because the general law provides that only contracts for *necessaries* and those for apprenticeship, employment, education and service are binding on the child.

Contracts for necessaries are for such things as the supply of food, medicines, accommodation and clothing. Contracts entered for products and services for comfort or pleasure are excluded, as are contracts for the acquisition of a legal or equitable interest in property of a permanent nature.

Because they lack legal capacity, minor shareholders may also not be appropriately constrained by the terms of any shareholders' agreement that is in place. Courts and statutes provide minors with the ability to exit the contract at the minor's discretion. This right does not belong to the other contracting party; it is only at the discretion of the minor.

If it became necessary to sell the child's shares there might be problems, as some agents may refuse to process the sale before they reach the age of majority, because of the legal issues involved. Applying for a court order might be required to facilitate the sale of a child's shares.

If a child does take on shares, the company's register of members will need to be updated accordingly. Dependent on the level of their shareholding and the nature of control, the child may also need to be recorded in the company's registers as a person of significant control.

Can a child be a director of a company?

Companies Act 2006 section 157 imposes a minimum age of 16 for appointment as a director. So while a minor can be a shareholder of a company, they cannot be a director until they are 16.

When does the settlements legislation apply?

The settlements legislation is contained in s.624 ITTOIA 2005. The legislation seeks to ensure that where a settlor has retained an interest in property, in a settlement, the income arising is treated as the settlor's income for tax purposes.

Whether or not the settlements legislation applies to an arrangement depends on the particular facts of the case. It is necessary to look at the arrangement as a whole. If there is a ***bounteous arrangement*** which effectively transfers income earned by one person to another, resulting in a reduction in overall tax liability, the arrangement may be liable to challenge under the settlements legislation. If there is no "bounty" or if a gift to a spouse is an outright gift which is not wholly, or substantially, a right to income, then the legislation will not apply. A purely commercial transaction or series of transactions at arms-length is outside the meaning of "settlement".

Most commonly, the legislation will apply where individuals seek to divert income to members of their family or to friends. A good test of whether or not the legislation could apply is to consider whether the same payments would be made to a person who acquired shares in a company or a share of a partnership at arms-length, or income is being paid simply because the recipient is a spouse, child, or some other individual the settlor might wish to benefit.

It is a common misconception that the settlements legislation applies only to arrangements involving a settlor's spouse or minor children. **ITTOIA/S624** makes it clear that the settlor is treated as having an interest in property if "***that property or any derived property is, or will or may become, payable to or applicable for the benefit of the settlor or his spouse in any circumstances whatsoever***." It is not necessary for the settlor's spouse or children to be the people to whom the income is transferred. If the settlor or their spouse retains an interest in the property, then the legislation can apply.

Example

Mr C is the sole director and owns all of the 1000 ordinary £1 shares in C Limited. His aunt, Mrs D, has always been very kind to him and he wants to thank her for this. He subscribes, at par, for 100 B shares, ***with no voting rights and restricted rights to capital*** of £10 per share in the event of winding up. He gifts the shares to Mrs D. Mr C then declares a dividend of £100 per share, with Mrs D receiving dividends of £10,000.

This is a bounteous arrangement and HMRC would apply the settlements legislation to the dividends. The property giving rise to the dividends cannot be looked at too narrowly as the shares alone. The wider arrangement must be considered. Because he is in effective control of the company Mr C retains an interest in the underlying property, as he could simply pay all future income arising to himself as director's salary or as dividends on the ordinary shares.

Settlement legislation: settlement for an unmarried minor child

ITTOIA/S629 applies to situations where income not caught by ITTOIA/S624 is paid, or made available to, or belongs to, a minor child or step-child (who is neither married nor in a civil partnership) of the settlor. A step-child includes the child of a civil partner.

For this purpose, ‘child’ includes a step-child and ‘relevant child’ means a minor child who is unmarried or not in a civil partnership.

Where ITTOIA/S629 applies, the income is deemed to be that of the parent for tax purposes, and is not treated as the child’s.

Where the total of the relevant settlement income of a child from settlements of one parent does ***not exceed £100 in any tax year***, the legislation does not apply in that year.

Example: income less than £100 not within ITTOIA/S629

A father makes regular gifts of cash to his two daughters aged 10 and 15, who deposit the money in building society accounts in their own names. The income arising to the children is £50 and £105 respectively and they have no other income. As the £50 income is less than £100, we would not treat it as the father’s income. However, for the daughter whose interest was £105, we would treat all the income as that of her father.

Example: £100 limit applies separately to each parent

A father makes regular gifts of cash to his 14-year-old son, who deposits the money in a building society account. The child’s mother gives her son a holding of shares in the family company. The child has no other income.

In one year, the building society interest is £80 and the dividends received are £120. The building society interest is less than £100 so we would not treat the income as that of his father. However, as the dividends exceed £100, we would treat the whole of the dividends as the income of his mother.

If one parent had made all the gifts, the full £200 would be treated as that parent’s income.

The following examples show how ITTOIA/S629 applies to non-trust arrangements:

Direct gift of shares to minor children

Mr and Mrs X each own 50 of the 100 issued ordinary shares in X Ltd. They each decide to give 10 shares to each of their children aged 12 and 15. The children each then hold 20 shares, 10 from each parent. We would treat the dividends paid to the children as the income of their parents.

Indirect gift of shares from parent

Mr J owns 60 of the 100 issued £1 shares in J Limited. Mr J is the sole company director and is the person responsible for making all the company’s profits because of his knowledge, expertise and hard work. On starting up the company, Mr J allowed his mother to subscribe £40 for 40% of the shares but shortly afterwards she gifted them to her grandchildren. The circumstances are such that the decision to issue 40 shares at par is a bounteous arrangement (as were the shares in Jones v Garnett). The true settlor here is Mr J rather than the children's grandmother. ITTOIA/S629 therefore applies and attributes the dividends received by the children to Mr J for tax purposes.

The following examples shows how ITTOIA/S629 applies to trusts:

Bare trusts

ITTOIA/S629 applies to treat the income belonging to the child as that of the parent for tax purposes whether or not it is paid to the child.

Example bare trust for a minor child

A parent creates a bare trust for a minor unmarried child. No payments are made out and the trustees retain all the income, which exceeds £100.

Although no income is paid to or for the benefit of the child, ITTOIA/S629 applies to treat the income as that of the parent because the income belongs to the child.

IIP trusts

The income arising to an interest in possession trust of which the child is a life tenant is treated as that of the parent for tax purposes.

Example IIP for a minor child

A parent creates an IIP trust of which three children are life tenants. Two of the three children are minors. ITTOIA/S629 applies to treat the income of the two minor children as that of the parent because the income belongs to the minor children.

Discretionary trusts

The income of such trusts does not belong to the child until a discretionary payment is made to, or funds are applied for the benefit of, the child.

Payments out of current income, accumulated or retained income, or capital (to the extent that there is sufficient retained or accumulated income to match them) made to or for the benefit of a minor child (who is neither married nor in a civil partnership) of the settlor are treated as the parent's for income tax purposes.

Example discretionary trust

A director owns all the shares in a family company. He sets up a discretionary trust for his 10 year old daughter and transfers 25% of this shareholding to the trustees. The trustees make a discretionary payment out of income to the child. ITTOIA/S629 applies to treat the payment from the trust to the child as the income of the parent.

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