



The voice of freelancing

Notes on proposals to tackle “income shifting”

Please note that this document was produced before the Government published its draft legislation; PCG's position however remains the same as set out here.

Overall PCG recommendations

PCG understands that the Government wishes to introduce a measure such that, when one person diverts income to another person for reasons of tax advantage, that advantage will no longer be available. This is on the basis that, where the second person did not contribute to the generation of that income, such a tax advantage would be “unfair”.

PCG recommends that the Government does not proceed with this measure, for reasons relating both to principle and to practice.

1) Principle

- the perception of “unfairness” is, in most real-world situations, illusory: where two people are exposed to the risk of a business failing, they should be entitled to share in the rewards if it succeeds
- such a measure would mark a sharp divergence between tax law and divorce law: a spouse might be entitled to over half the value of a business in a divorce, but while married they may not be entitled to share any of the profits¹
- the Treasury has stated that “income shifting” runs counter to the principle of independent taxation: in fact, it is the natural consequence of independent taxation, which was foreseen and accepted when independent taxation was introduced
- married couples enter into financial arrangements on the basis of being married: it is wholly inappropriate to expect spouses to enter into “commercial arrangements” with one another

2) Practice

- such a measure would impose crushing burdens on hundreds of thousands of jointly-owned businesses: it would oblige them to record and value every contribution made to the business, which would be extremely time-consuming and often also extremely difficult
- inevitably, such a measure would be so complex that self-assessing a tax liability with any certainty would be impossible, particularly with regard to valuing contributions and ascribing these values to different partners
- such a measure would reduce taxpayers’ willingness to meet their obligations: they would be unable to self-assess their liabilities with any confidence, so many would make a token effort at compliance and then just hope not to be investigated
- HMRC will not be able to enforce these rules across the board: it would require massively resource-intensive checks on huge numbers of taxpayers
- taxpayers will therefore be faced with a lottery regarding who will be investigated and who will not: this would, itself, represent considerable unfairness.
- even where a co-owner does not earn revenue directly for a small business, it is far from clear that there is no legitimate business case for having more than one owner: data from PCG’s membership surveys shows that companies with one fee-earner and two workers have higher turnovers than those with only one worker (see Appendix)

PCG recommends instead that the Government should consider, in full consultation with all interested parties, the taxation of small businesses from first principles and introduce measures to clarify and simplify the tax system. The Government clearly currently feels that it is not receiving the right amount of tax from them, while businesses themselves feel that the system is too complex and burdensome. Nobody is satisfied with the current situation and the Government should concentrate its efforts on remedying the fundamental problems that currently exist.

¹ References to married couples and spouses will be taken to apply equally to civil partners throughout.



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The discussion paper 'Small companies, the self-employed and the tax system' (2004) contained much that was positive, but PCG understands that the activity around it has now ceased and resulted only in the increases in the small firms' CT rate announced in this year's Budget. The paper would be a good starting-point for a more thorough review of small business taxation.

PCG notes further that the Government is currently unable to monitor revenues raised by individual tax measures within, for instance, PAYE incomes generally. It nevertheless uses estimates of likely revenues when seeking to justify new measures. This inability to monitor revenues can lead, PCG feels, to poor and unaccountable decision-making: we recommend that systems should be instituted to monitor revenues raised by new tax measures before further reforms are introduced. Failing that, the Government should desist from justifying new tax measures on the basis of revenues that it knows it will never be able to monitor.

Comparison with Managed Service Companies

PCG feels that a comparison with the recently-introduced MSC rules would be instructive in illustrating our objections to a measure to "tackle income shifting".

1) The case for reform of MSCs was clear

- PCG agreed that MSC providers were using corporate forms for purposes for which they were clearly not intended, and that individuals were therefore gaining the tax advantages of being in business without taking the full responsibility
- in the case of "income shifting" it is not clear that there is any "unfairness": nothing new is happening that was not envisaged prior to the introduction of independent taxation, and there is no reason why any "unfairness" can be said to have arisen since then.

2) The intended scope of the MSC rules was clear, and restricted

- the consultation paper stated that there were about 150 key MSC providers, and HMRC have since made it clear that it is targeting these companies when enforcing the new rules
- in the case of "income shifting" hundreds of thousands of jointly-owned businesses would potentially be within scope.

3) The impact of the MSC rules has shown that considerable burdens can be placed on parties outwith the intended scope of the legislation

- the MSC rules have caused considerable uncertainty and resentment among freelancers and contractors who, for instance, operate their own limited companies, even though they were clearly and repeatedly stated to be outside the intended scope of the legislation
- due to the difficulty of identifying the relevant companies in legislation, many fear that the end result is ambiguously drafted, and that HMRC may at some point attempt to use the new rules against contractors, for instance by seeking to infer that their accountant is a "scheme provider"
- recruitment agencies in particular have been going to great lengths to be able to show themselves to be outside the rules: this has involved taking extensive legal advice, undertaking high volumes of correspondence with their clients and contractors, and keeping records to that end, even where they have been confident of remaining out of scope
- reports have reached PCG of accountants and agencies ceasing to deal with contractors using limited companies altogether, for fear of being deemed a "provider".

The impact of the MSC rules overall shows that even parties nominally outside scope will feel it necessary to go to great lengths to be able to demonstrate that they are not caught by new tax legislation if challenged by HMRC. Although PCG remains satisfied that its members are outside the scope of the rules, our optimism at the time of the consultation about the extent of the impact on parties not in scope was perhaps, with hindsight, a little misplaced.



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Given that any “income shifting” measure will inevitably be targeted much more broadly than the MSC rules, these consequences would be felt far more widely and far more keenly following its introduction: many jointly-owned businesses, whether in scope or not, will have to take steps to demonstrate their compliance. These steps will inevitably be extremely burdensome.



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Scenarios that would be affected

Identifying all the scenarios that would be affected is very difficult: most business statistics do not provide a ready break-down of how the income from businesses is distributed.

We can, however, make some informed guesses. The SME Statistics issued by the Department for Business Enterprise and Regulatory Reform show that 73% of all businesses have no employees; 21% of these - 693,000 - are companies (61% of the 1,145,000 companies operating in the UK).

Within PCG's membership, 82% of members have businesses with only one fee-earner. Of these, 40% consist of companies with two people performing work for the business. If we project this across the population of UK companies with no employees, we see 277,200 companies that the Government potentially intends to target. This calculation involves a degree of conjecture, of course - it is far from clear how representative PCG's members are of companies generally, though there is no reason to assume that they are anomalous - but it does show that, even when considering the smallest limited companies, a large number of enterprises will be affected.

PCG does not have sufficient data to be able to repeat this estimate for all businesses, as relatively few of its members are unincorporated; but given that there are over 3 million businesses overall without employees, the figure for the total number of enterprises within scope could potentially be very substantial, perhaps even the greater part of one million.

Scenario A

Mr A is made redundant from his permanent job in IT. He and Mrs A decide that Mr A will work on a freelance basis and visit their accountant to take advice: on his advice, they acquire, on a 50-50 split, a limited company (A Ltd) through which Mr A sells his services, for which the company pays him a salary, but no effort is made to assess the "market rate" for such work and match the salary to it.

Mrs A undertakes administrative duties and keeps the books. She is paid a salary, but no effort is made to assess the "market rate" for such work and match the salary to it. Mrs A spends the rest of her time raising the couple's children and has no other source of income.

Money remaining in the company is paid as dividends equally to both.

Is this "income shifting" in the sense outlined in the ministerial statement and PBR?

Yes.

Is this "unfair"?

PCG does not believe that this scenario is unfair. The livelihood of the family unit rests on the success of A Ltd: if it fails and, for instance, Mr and Mrs A are unable to meet the repayments on the mortgage they have on the family home, it is not just Mr A who will be affected, but Mrs A and their children too. This is distinct from the situation if Mr A had been an employee: such a position would come with in-built protections and other benefits such as paid sick pay, holiday pay and training. In addition, small business owners are often required to make personal financial guarantees, despite their businesses being incorporated. It is therefore fair that Mrs A is entitled to a share in the reward from the business, as she is exposed to a share of the risk.

If Mr and Mrs A were to get divorced, Mrs A would be entitled to half the value of the company: if it is "unfair" that Mrs A should be entitled to receive - and be taxed on - dividend income from A Ltd, so it must be unfair that she would be entitled to half the value of the business on divorce. PCG suggests that, in fact, no unfairness resides in either scenario.

How could income be re-assigned for tax purposes?

This could be achieved in a number of ways. Three solutions suggest themselves:



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- Mr and Mrs A could pay dividends as before, but pay tax on Mrs A's dividends as if they were Mr A's income; given that Mrs A makes some contribution to the business, it should be possible to make allowance for this when calculating this tax liability
- Mr and Mrs A research market rates among employees for the work they perform and award themselves salaries commensurate with these; any remaining money in the company is distributed as a dividend to Mr A, or dividends to Mr and Mrs A in the same proportion as they were paid their salaries
- Mr and Mrs A research market rates among employees for the work they perform and award themselves salaries in proportion to these, but not actually at the full market rates: money is then left in the company, which can then be distributed as a dividend to Mr A, or dividends to Mr and Mrs A in the same proportion as they were paid their salaries

Whatever course of action they adopt, Mr and Mrs A will still face considerable uncertainty over whether they have assessed their tax liability correctly, and would still have to demonstrate as much to a tax inspector if required to do so.

What would be the administrative impact?

Mr and Mrs A would have to record and value all work done, and conduct research on market rates for permanent employees. This would be a very difficult exercise: ascribing a value to a given activity is not as straightforward as finding the comparable market salary.

Consideration must also be given to the extent to which the activity enhances the profitability of the business: if an hour's administrative work worth £10 is undertaken by Mrs A, and frees up Mr A to undertake an extra hour of work chargeable at £50, the value of the hour of administrative work to the business is clearly more than £10. Calculating exactly what its value is, however, is extremely difficult.

With this in mind, Mr and Mrs A would not be able to self-assess their tax liabilities with any certainty and would inevitably face a complex, lengthy and distressing tax investigation if HMRC decided to look into their affairs.

Scenario B

Mr B runs a business selling specialist car parts over the internet, B Spare Parts. He sources and sells the parts, and takes full responsibility for all administrative functions of the business. When he set it up, however, Mrs B designed and constructed the website through which all the business's sales are made, without charge to the business. Beyond being on-hand to correct occasional problems with the website, she plays no part in the business, and has no other income. B Spare Parts distributes the profits of the business equally to Mr and Mrs B.

Is this "income shifting" in the sense outlined in the ministerial statement and PBR?

Yes.

Is this "unfair"?

No - Mrs B's future is equally bound up with the business. She is exposed to the risk of its failure, and is entitled to share in the rewards if it succeeds. She would be entitled to half the value of the business in the event of a divorce.

How could income be re-assigned for tax purposes?

The distributions could all be taxed as Mr B's income, but this would clearly be unfair: Mrs B's contribution to the business is essential for allowing it to trade, and a valuation of this would have to be made and taken into account.



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What would be the administrative impact?

Mr and Mrs B would have to record and value their work on the business, although for Mrs B this would only involve recording occasional website maintenance.

They would also have to value the website and its importance to the business. This would be a very difficult exercise: as the website is essential for the business to generate any profit at all, it is clearly worth more than any figure that would be arrived at by simply researching the market rate of a website developer and multiplying it by the number of hours it took to create the website (and that calculation would be very difficult of itself: should Mrs B's work be compared to that of a website developer working as an employee, or a web development company engaged commercially?).

Mr and Mrs B would not be able to self-assess their tax liabilities with any certainty and would inevitably face a complex, lengthy and distressing tax investigation if HMRC decided to look into their affairs.

Scenario C

Mr C owns 50% of an engineering company, C Ltd, employing 50 people. His wife has owned the other 50% from the time when he founded it, shortly after they married. Initially she provided some administrative support, but she has now not done so for a substantial number of years.

Mr C is paid a salary as the company's Managing Director. The company distributes profits to Mr and Mrs C as dividends of equal size each year.

Is this "income shifting" in the sense outlined in the ministerial statement and PBR?

Yes.

Is this "unfair"?

Given that the relative positions of the two spouses are the same as in scenario A in the sense entailed by the ministerial statement and PBR - ie Mr A and Mr C are directly engaged in generating revenue, while Mrs A and Mrs C are not - it must logically be the case that the tax treatment should be the same as in scenario A. It is therefore not unfair for Mrs C to receive dividend income from C Ltd: her future is equally dependent on the company's success, and she would be entitled to at least half of the value of the company in the event of a divorce.

How could income be re-assigned for tax purposes?

Given that Mrs C has no direct involvement with the company, it would be relatively straightforward to tax her dividend income as Mr C's. In practical terms, they may wish to consider altering the share structure of the company so that it is wholly owned by Mr C, although there may be other reasons for retaining the present structure.

What would be the administrative impact?

As C Ltd has its own dedicated administrative staff, there will be no burden on the couple involving calculating the inputs of Mrs C, but a modest burden on the dedicated administrative function of C Ltd, or its accountants. There would be a cost associated with investigating the new rules and assessing tax within them.

Scenario D

Mr and Mrs D run a business, D Ltd, in the same circumstances as Mr and Mrs C, but Mrs D provided 100% of the initial capital - a substantial amount - when the business was started.

Is this "income shifting" in the sense outlined in the ministerial statement and PBR?

Unclear - Mrs D is not working for the business, but her dividend income could be said to be a return on her investment.



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Is this “unfair”?

No - in addition to the reasons cited in scenarios A and C, Mrs D’s investment in the business provides a further justification for the payment of dividends.

How could income be re-assigned for tax purposes?

It is not clear that this would be necessary according to the Government’s view of “income shifting”. If it were to be necessary, it is hard to see how it could be decided what part of Mrs D’s dividends represented a return on her initial investment and what part represented income that “ought” to be Mr D’s.

What would be the administrative impact?

D Ltd would have to take a guess regarding whether or not the new rules applied, and if so, how to apply them. Records of Mrs D’s involvement with the business would not have to be kept, as she has none; historical records regarding her investment would no doubt be retained, however.

Scenario E

Mr and Mrs E run a business, E Ltd, in the same circumstances as Mr and Mrs A, except that Mrs E also earns fees for the company. She has a more specialised skill set than Mr E and therefore commands higher rates. In a typical year, she generates 70% of the company’s revenue, despite working for half as long as Mr E. Nonetheless, Mr and Mrs E take equal dividends.

However, the company has a bad year, and even after dividends are paid, Mr E’s total income for the year is still within the basic rate tax band.

Is this “income shifting” in the sense outlined in the ministerial statement and PBR?

Unclear, but probably part of Mr E’s dividend should be taxed as Mrs E’s income under the logic of the ministerial statement.

Is this “unfair”?

No - Mr and Mrs E are clearly in business together, sharing the risks and sharing the rewards.

How could income be re-assigned for tax purposes?

It is not clear how this income should be re-assigned: Mr E has worked longer hours than his wife and has shown the same dedication to the business. Should his income be re-assigned to Mrs E even though she has spent less time on the business? He is equally exposed to the risk associated with running the business, so he should be entitled to an equal reward.

What would be the administrative impact?

Mr and Mrs E would have to keep records of all work done, and conduct research on market rates for permanent employees. This would be exactly the same administrative burden as in Scenarios A and B, as Mr and Mrs E would still have to demonstrate to any HMRC inspector that they did indeed generate income in such a way as to justify their decisions regarding distributions of profits and self-assessment of tax liabilities. The consequences of not doing so could be a lengthy and expensive tax investigation.

Scenario F

Mr F has acquired a substantial share portfolio over a number of years, and then gets married. He gifts half of his portfolio to his wife, who has a full-time job. She subsequently leaves work and has a baby: she devotes most of her time to raising their child and has no source of income other than from her shares. She manages her shares actively, however, which includes trading them without consulting Mr F. Her portfolio, over time, performs markedly better than the portfolio with which Mr F has left himself.

Is this “income shifting” in the sense outlined in the ministerial statement and PBR?

Yes, as it involves income “in the form of distributions from a company (dividends)”.



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Is this “unfair”?

No - this is an entirely normal agreement between two spouses. Mrs F takes responsibility for managing her new assets, and the income that may or may not flow from them following her acquisition of them is entirely her responsibility. She would also be entitled to at least half of Mr F’s assets in the event of a divorce in any case.

How could income be re-assigned for tax purposes?

Any income arising from the shares could be taxed as Mr F’s income. However, this would not take into account Mrs F’s superior management of the investments, which would not be fair. Calculating this difference would be extremely difficult, however - although Mr F started with the same value of shares and they have not gone up in value so much, they are not identical shares and so it is not possible to compare their performance in any great detail. If a long time has passed between Mr F gifting the shares and the new measure coming into force, disentangling exactly what should be “Mr F’s income” from among a potentially very long chain of transactions will be monstrously difficult.

What would be the administrative impact?

Mr and Mrs F would have to keep complete records regarding the management of their shares, and would not be able to assess their tax liabilities with any certainty.

Scenario G

Mr G has acquired several properties over a number of years, and then gets married. He gifts one property, a flat, to his wife, who has no other income. She subsequently has a baby and devotes her time to raising their child. They live in a separate property, and decide to rent out the flat. Mrs G invests some of her own money, over time, in maintaining and improving the flat; Mr G takes no active role in managing the flat.

Is this “income shifting” in the sense outlined in the ministerial statement and PBR?

No, although there is no logical reason why it should not be. Ultimately, Mrs G is still in receipt of incomes from an investment originally financed by her husband. This is not to say that this is “unfair” - indeed, PCG believes that it is not - but if Scenarios A-F and H are to be categorised as “income shifting” it is hard to see why this should not.

Is this “unfair”?

No - this is an entirely normal example of an agreement between two spouses. In renting out the flat, Mrs G takes on a range of legal responsibilities as a landlord, and has to compete in the property market on a commercial basis.

How could income be re-assigned for tax purposes?

The rental income could be re-assigned and taxed as if it were Mr G’s, but for this to be fair an allowance would have to be made for the time spent by Mrs G in arranging and managing the let, the legal responsibilities she has taken on as a landlord and the money she has invested in the flat.

What would be the administrative impact?

All time spent administering the let, money spent on improving the flat and the responsibilities of being a landlord would have to be recorded and valued. It may also be necessary to investigate the rental value of the flat at the time when it changed ownership, in relation to changes in the rental market and the current rent attracted by the flat, in order to assess the value added to it by Mrs G. This would be a complex task.

Scenario H

Mr and Mrs H have run a seaside B&B for many years, performing all duties interchangeably over that time and both putting in similar hours. However, Mrs H’s health declines and Mr H takes on most of the work of running the B&B. They continue to receive profits from the business, which is not incorporated, equally.



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Is this “income shifting” in the sense outlined in the ministerial statement and PBR?

Yes.

Is this “unfair”?

No - Mr and Mrs H have worked jointly to build the business, and have run it together for many years. Their livelihoods depend on it equally: they are exposed equally to all risks associated with the business. Mrs H would be entitled to at least half of the value of the business in the event of a divorce.

How could income be re-assigned for tax purposes?

In deciding how much of Mrs H's income should be taxed as Mr H's, they would have to place a value on the work done by Mrs H in building the business, maintaining the building, buying items necessary and so on.

What would be the administrative impact?

Mr and Mrs H would have to record and value all work undertaken as part of the business. As this would be an extremely difficult exercise, they would not be able to assess their tax liabilities with any certainty.



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Appendix: turnover of jointly-owned companies

For the last two years, PCG has asked its members about the structure of their businesses in our annual membership survey.

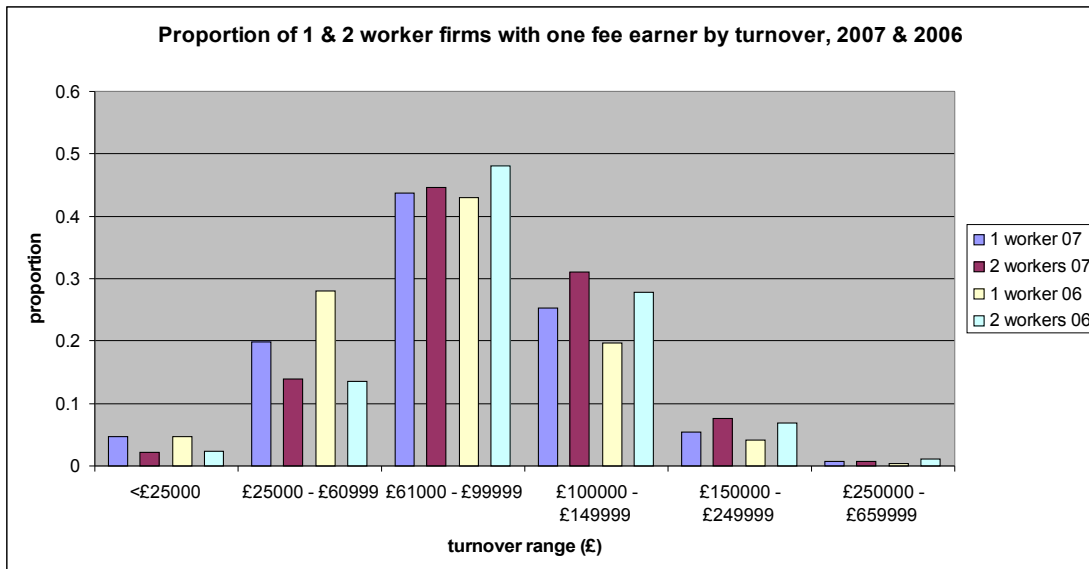
The questions asked relate to the number of fee-earners in a business, and the number of workers. In the businesses where there are more workers than fee-earners, not all of those “extra” workers will necessarily be shareholders: some may be accountants or other parties that are paid for commercial services via the company’s payroll, for administrative ease. However, we feel that the results can be taken as a fair indication of what proportion of members’ companies are jointly-owned.

Of PCG’s membership, 96% run limited companies and 82% have one fee-earner.

Of the businesses with one fee-earner, the proportions with one, two or more workers are set out in the table below (given the very low proportions of non-limited company businesses, these have not been excluded from the data).

	2006 (%)	2007 (%)
1 worker	57.6	59
2 workers	40.5	39
>2 workers	1.9	2

The chart below compares the turnover data from the same surveys with the numbers of workers and fee-earners. For companies with lower turnovers, having one fee-earner but two workers seems to be a disadvantage; for companies with turnovers over £61,000, however, the presence of an additional worker seems to be positive, however.



Even though the additional worker does not directly earn fees, their presence correlates with higher turnovers. This stands to reason: the additional support provided by the extra worker will free up the fee-earner to generate more revenue for the business.

Quantifying the additional value brought by the extra worker is, however, very difficult: almost certainly a comparison of “market rates” for particular skill-sets offered by contractors and those provided by



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secretaries, book-keepers, PAs etc. would not reflect the value. Moreover, the types of support offered by an additional worker are potentially so varied as to make a generalisation based on these data impossible: it might involve *ad hoc* administrative support, a dedicated and formal administrative function, trained and qualified book-keeping or any other number of variants. It is therefore not currently possible to assess the value added by extra workers generally, other than to observe that it seems to exist for businesses with middling to high turnovers.

It can be observed that the benefit of the extra worker was slightly more pronounced in the survey data from 2006 than those from 2007. One reason for this might be that PCG members reported slightly higher turnovers overall in the 12 months to April 2007 than in the 12 months to April 2006: it may be, therefore, that the value of the extra worker is higher when market conditions are not so buoyant, and businesses are facing difficulties.