

# Arctic shift

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The Government has published draft legislation and guidance on income shifting. ANNE REDSTON provides an overview and suggests that a complete change of approach is required

## Key points

- The background to the consultation document.
- Who will be affected and what are 'relevant arrangements'?
- The conditions and terminology.
- When will a tax advantage occur?
- A review of the Government's guidance.

Earlier this year, HMRC were defeated in the *Arctic Systems* case. The Government immediately promised amending legislation, and in December published a consultation document (see <http://snipurl.com/incomeshift>). In so doing it introduced a new verb into the tax lexicon.

Existing only in the plural form, it conjugates as follows: 'We share rewards, you split profits, they shift income'.

The verb morphed quickly: in 2003, HMRC guidance talked about 'dividing' income; earlier this year, the Pre-Budget Report called it 'income splitting', while the new consultation document is entitled 'income shifting'. The word 'shift' is of course not normally used for income, and is only one letter removed from 'shifty', defined by the *Oxford English Dictionary* as 'deceitful or evasive'.

This word, 'shifting', is unlikely to be accidental. Ministers have repeatedly asserted that they hold the moral high ground in this area. The opening paragraphs of the consultation document reiterate this, stating that the Government's purpose is 'to provide a fair tax system by removing the tax advantage gained from income shifting', and thus preventing 'the fairness of the income tax system (being) undermined'.

## A fair policy?

But is the policy fair? After all, tax law (rightly) allows the division of property or savings assets between spouses, even where this division is carried out explicitly to allow the lower-earning spouse to use his or her personal allowances and basic rate bands. The Government has confirmed that it has no intention of attacking this type of transfer.

Surely a policy which permits the diversion of property or savings income is more difficult to defend than one which allows profits to be divided between family members participating in a small business; see **Example 1** and **Example 2**.

## Example 1

Mr and Mrs Scrimp make and sell organic jam. Mrs Scrimp works four days a week making jam; Mr Scrimp does the books and delivers to customers. They both agree that she works twice as many hours as he does, but are unclear how to value their work. Currently each takes a small salary and they share dividends 50:50.

## Example 2

Mr Croesus owns a buy-to-let property portfolio which he manages alongside his City job. Mrs Croesus does not work and has no income. Mr Croesus moves ownership of the properties to his wife, but continues to manage them.

In **Example 2**, Mrs Croesus secures the tax savings even though she does nothing to earn the income. In contrast, Mr Scrimp in **Example 1** plays an essential role in the family business. There is thus some commercial justification for his income; there is none for Mrs Croesus's.

Furthermore, a transfer of property or savings must be significant if it is to generate income sufficient to utilise a spouse's allowance and basic rate band. It is thus a tax planning opportunity available only to the rich. In contrast, most of the small family businesses targeted by the new legislation are likely to be low to middle income households.

## Background

Having set out the purported policy reasoning, the consultation document then moves on to the case law background. As most tax advisers are well aware, in July 2007 Mr and Mrs Jones and their company, Arctic Systems Ltd, won a long legal battle against the tax authorities (*Garnett v Jones* [2007] STC 1536).

HMRC had sought to use the settlements legislation (then contained within TA 1988, s 660A and now in ITTOIA 2005, s 625) to reallocate Mrs Jones's dividends to Mr Jones for tax purposes.

The House of Lords found unanimously for Mr Jones. They held that, although there was a settlement, the outright gift exemption applied and Mr Jones's dividends were thus not reallocated to his wife. This case has been well covered by previous editions (for example: Mike Truman's article, 'Geoff Jones and the lost Garnet(t)', *Taxation*, 2 August 2007, page 126) and thus is not discussed further here.

The consultation document states that, as a result of Arctic, 'it is now clear that the settlements legislation is not sufficient to address all cases of income shifting', and consequently:

'the Government is committed to ensuring that, with clear and modern legislation, such cases can be dealt with effectively and that clarity can be given to businesses and their advisers.'

Readers must form their own view as to whether the Government has succeeded in producing 'clear and modern legislation' which will provide 'clarity' for them and their clients. The consultation is open until 28 February, and comments can be e-mailed to [incomeshifting.consultation@hm-treasury.gov.uk](mailto:incomeshifting.consultation@hm-treasury.gov.uk).

While there is no substitute for reading the entire document, the rest of this article summarises the proposals and considers some of the issues raised.

## Outline

The proposed legislation comes into force on 6 April 2008, and applies where there are 'income shifting arrangements that make use of companies or partnerships to gain a tax

advantage'. The rules are wider than the husband and wife scenario of Arctic, and may include:

- Companies owned by parents and children.
- Companies owned by brothers and/or sisters.
- Family partnerships of most shapes and sizes.
- Companies or partnerships owned by unmarried couples.
- Companies or partnerships owned by same sex couples, whether in a civil partnership or not.
- Most business structures where capital has been invested by a connected party.

The draft legislation is set out at Appendix A to the consultation document. In this article the statutory references are to these draft clauses; the paragraph references are to the draft guidance at Appendix B.

The new rules will apply where there are 'relevant arrangements'; as long as a number of specific conditions are met. Both are discussed below.

## Relevant arrangements

'Arrangements' are widely defined in the draft legislation to include 'any agreement, understanding, scheme, transaction or series of transactions (whether or not legally enforceable)' (s 681E(6)). There is no time limit, so an arrangement may cover more than one tax year (paragraph B18).

Arrangements will be 'relevant' if they are 'not genuine[ly] commercial' and 'it would be reasonable to draw the conclusion, from all the circumstances of the case, that the purpose, or one of the main purposes, of the arrangements is the avoidance or reduction of a charge to income tax' (s 681E(1)).

Further sub-clauses expand what is meant by commercial, but for most purposes a non-commercial arrangement is one that has been entered into on 'terms other than those that would have been made between persons not connected with each other dealing at arm's length' (s 681E(2) – (5)).

In other words, a form of transfer pricing is required to establish whether or not the terms of the arrangement are those which would have been acceptable between independent third parties.

## Specific conditions

In addition, for the legislation to apply, all of the following conditions must be met:

- Condition A – individual 1 is party to, or has power to control or influence, the relevant arrangements;
- Condition B – individual 1 forgoes income and the forgone income is individual 2's for the relevant tax year;
- Condition C – individual 1 has the power to control or influence the amount that is shifted; and
- Condition D – the shifted income consists of distributions of a company or profits of a partnership.
- Finally, the tax paid by individual 1 and individual 2 together must be less than it would have been had they not shifted income; i.e. a tax advantage must have been obtained (s 681B and s 681D).

There are a number of key terms here, notably 'party', 'control', 'influence', 'forgo' and 'tax advantage'. Each is discussed below.

## **Parties, control and influence**

Condition A is met if the individual who is forgoing income is 'party to, or has power to, control or influence, the relevant arrangements'. Paragraph B16, referring to 'party', states that this word 'is meant to be interpreted in its widest sense'.

There is, of course, extensive case law on what is meant by being 'party' to an 'arrangement', but if that proves insufficient, the condition is also met if the individual has the power to 'control or influence' the relevant arrangements.

This phrase also reappears in Condition C, which requires that the individual 'control or influence' the amount of income transferred. 'Control' has been much discussed in tax cases, but the same is not true of 'influence,' which is thus likely to bear its ordinary, very wide, meaning. This is confirmed at paragraph B34 of the consultation document:

'The term "power to control or influence" is not defined and is intended to be interpreted in its widest sense. In particular, it is intended to go wider than the definition of "control" contained in ITA 2007, s 989 to ensure that it covers circumstances where individual 1 can affect the timing, amount and direction of the income being shifted to individual 2.'

In a family business environment, each party is likely to have some influence over the others, and one can thus assume that Conditions A and C will almost always be met.

## **Forgoes income**

An individual is treated as having forgone income if:

- a) he is entitled to receive the income but does not receive it; or
- b) he would be entitled to receive the income but because of the relevant arrangements does not receive it; or
- c) having regard to any work done by him and all other relevant circumstances, he might reasonably be expected to receive the income but does not do so (s 681F).

The guidance notes say (at B26): 'The rule is widely drawn to ensure that it covers circumstances where the income forgone changes form or is received either directly or indirectly by individual 2'.

An example of how this will operate is given at paragraph B29, but because the second individual makes no contribution to the business, it is unduly simplistic. The consultation document does have the grace to add that 'in practice, the facts in each case will often be more complex'.

## **Tax advantage**

There are two tests to consider under this heading: first, a tax advantage must have been obtained (s 681D), and secondly 'it must have been reasonable to draw the conclusion' that this advantage must have been 'the purpose, or one of the main purposes, of the arrangements' (s 681E(1)).

The consultation document implies that these tests act as some sort of filter, so reducing the numbers of businesses affected by the new rules. But any filtering effect is largely illusory, for three reasons.

First, the meaning of 'tax advantage' is very broad. ITA 2007, s 683(1) (formerly TA 1988, s 709) defines it as 'a relief from income tax or increased relief from income tax, a repayment of income tax or increased repayment of income tax; the avoidance or reduction of a charge to income tax or an assessment to income tax, or the avoidance of a possible assessment to income tax'.

Paragraph B22 of the consultation document confirms that this wide interpretation is intended, although the new legislation does not specifically invoke the ITA 2007, s 683 definition.

Secondly, extensive case law has established that whether a taxpayer has avoidance as his 'sole or main purpose' is a subjective test which depends on the mindset of the individual. The question is to be decided by the Commissioners in the light of the evidence (CIR v Brebner 43 TC 705). Whether tax avoidance is the sole or main purpose is thus a question of judgement. This is never an easy matter, and most family businesses will need to take advice.

In addition to this general case law background, the guidance notes (at B23) seek to widen the net, stating that (my italics) 'if any participant has a main purpose of achieving a tax advantage, that will constitute a main purpose of the arrangements'.

Thirdly, the draft legislation goes even further than the existing law on tax avoidance: the test in s 681E is met if (again, my italics) 'it would be reasonable to draw the conclusion' that there is a tax avoidance purpose. This moves the test from the subjective intention of the individual to the subjective (albeit 'reasonable') view of the HMRC officer about that individual's intention. It is very much hoped that, if this legislation does make it onto the statute book, that this subparagraph is deleted.

## The guidance

The legislation is thus widely drafted; the key question is how one knows when it applies. According to the consultation document (my italics):

'The Government is keen to ensure that the proposed new legislation is clear and that administrative burdens on business are minimised. The Government would welcome views on whether the guidance achieves these aims' (paragraph 1.18).

It is deeply dispiriting to find that even the Treasury do not believe the legislation to be clear on its face. A lack of clarity is understandable when an ambiguity emerges at a later date, long after draft legislation has passed into law; it is far from acceptable ab initio, before the statute has even been discussed by Parliament.

For clarity we must therefore turn to the guidance. This runs to ten pages and begins by setting out questions which seek to establish whether income has been 'shifted' to an individual, including:

- How much work has been done by that individual?
- What type of work has been carried out?
- How much responsibility does the individual have for key decisions?
- How much risk does the individual take on (including using a jointly-owned asset as collateral for a business loan)?
- How much capital has been invested by the individual?

It should be noted that these do not constitute 'an exhaustive list' (B53); specifically, when there is an HMRC enquiry, paragraph B63 states the business may be asked to produce documentation demonstrating:

- how an individual has arrived at the amount of the income shifted;

- the nature and extent of the work done by individual 2, which may include contracts of employment, time sheets, board minutes, any research done on the market rates of pay for the duties undertaken by individual 2, etc;
- the amount of capital or loans invested in the business by individual 2, which may include copies of accounts, bank statements, loan agreements, shareholder or partnership agreements; and
- the nature and amount of personal guarantees provided by individual 2, which may include copies of accounts, bank statements, loan agreements, shareholder or partnership agreements.

The guidance further indicates that businesses will have to document not only their actual borrowings, but support for the notional return provided on capital introduced by the parties.

For example, they may have to demonstrate that the return on capital is equivalent to the interest rate which would have been paid to a third party had the capital been provided on an unsecured basis (see Box B4, example D). This may involve obtaining quotations for hypothetical investments – assuming, of course, that a third party would be willing to make the investment at all.

As a final sting in the tail, the impact assessment (under the heading ‘unintended consequences’) warns that:

‘Individuals who genuinely pay the right levels of tax but whose businesses are structured in such a way that they may look like those who shift their income may be picked up by risk assessment in HMRC’s compliance strategy.’

However, will such businesses have assembled the raft of evidence set out above, so that when subject to enquiry, they can prove they are outside the rules?

## The examples

The document is rich in worked examples, the first of which (at Box 1.1) aims to set out ‘the tax advantage which may arise through this shifting of income’. Sadly, this calculation is significantly flawed: it forgets that income paid as dividends has first been subjected to corporation tax (one might mischievously speculate, in the alternative, that next year’s Finance Bill is re-introducing a 0% band for small businesses).

If corporation tax had been taken into account in this example, the total tax paid on an income-sharing basis would have been £12,000, not zero (as stated in the example). If the Treasury is using similar methodology for its overall calculations, this may explain why the Government is so concerned about the tax loss through income-sharing.

The main body of the examples are at Appendix B. A detailed analysis is beyond the scope of this article, but it is noteworthy that the new rules are likely to apply where:

- insufficient reward is being taken from the business in relation to capital introduced, see examples 3 and 12;
- an individual withdraws temporarily from a business (other than for sickness or maternity) unless the share of profits reduces to reflect this withdrawal (example 10);
- the business owner passes shares to the next generation as part of a retirement strategy, but still continues to work in the business (example 17).

These examples illustrate the wide scope of the rules, and how difficult it will be to escape them. Example 17 makes one wonder how people will pass on family businesses without incurring unexpected tax charges.

## Accumulated income

The legislation will apply 'to any income that forms part of individual 2's income on or after 6 April 2008, even where the shifted income is derived from an earlier period'; see paragraph B12. Affected businesses may thus want to consider distributing accumulated reserves before the beginning of the next tax year.

## Impact assessment

The consultation concludes with an impact assessment. This has been signed by the Minister as representing 'a reasonable view of the likely costs, benefits and impact of the leading options'. A separate article is required to do this document justice, but the following points are noteworthy.

- Despite the complexity of the rules, the ongoing costs for business of working out whether they fall within the legislation are stated to be zero.
- Even more remarkably, the tax changes are predicted to save businesses £200,000 a year. The basis for this assertion is that 'if 1,000 partnerships change status to become a sole trader, the administrative burden saving is estimated at £200,000 per year'.
- Although these rules are based on judgement, and thus resource-intensive, HMRC will incur 'negligible' costs policing them.
- The question 'does enforcement comply with the Hampton Principles' has been answered with a bald 'yes' – but it is difficult to see how these proposals fit with key Hampton Principles such as 'All regulations should be written so that they are easily understood, easily implemented, and easily enforced' or 'Regulators should recognise that a key element of their activity will be to allow, or even encourage, economic progress and only to intervene when there is a clear case for protection'.

The Cabinet Office recently carried out a 'capability review' of HMRC. One 'urgent development area' is 'evidence based policy making'. This impact assessment illustrates the problem: it is a perfect example of policy-based evidence-making.

## Conclusion

In case anyone was in any doubt about the scope and purpose of the consultation, the impact assessment confirms that 'the Government is not consulting on the options available', and that, of course, is the problem. Being invited to fiddle with the formatting is insufficient: this is a problem of policy, not phraseology. Imposing detailed transfer-pricing analysis on small businesses in exchange for tiny increases in the tax take is burdensome and disproportionate.

Forget income-shifting: what is needed now is paradigm-shifting, defined by the *Oxford English Dictionary* as a 'fundamental change in approach or underlying assumptions'.

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