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Commentary on the “Income Shifting” consultation document

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1. Comment on the consultation document

This document has been produced to complement PCG’s formal response to the Treasury and HMRC consultation paper “Income shifting: a consultation on draft legislation.” It consists of a detailed commentary on the consultation document, including the draft legislation, draft guidance and draft Impact Assessment.

PCG is deeply disappointed by the conduct of this consultation, and in particular with the presentation of the issues in the consultation document: it is highly partisan and much of its contents could justifiably be called “spin”. It does not offer a fair presentation of the relevant facts, and presents arguments that are neither conceptually sound nor based on facts.

1.1 The Government believes that it is right for everyone to pay income tax on their own income. This principle, by which individuals are taxed on their income independently of others and of their personal choices, ensures that the income tax system is fair and remains progressive.

This assertion embodies the false assumptions highlighted in Section 3 of PCG’s main response document regarding what is an individual’s “own” income: by doing so, it is extremely loaded.

1.2 The Government believes that the fairness of the income tax system is undermined if some individuals are able to dissociate themselves from income that they would have received in order that the income is taxed in the hands of another individual at a lower rate. This is known as income shifting (or income splitting).

“Income shifting” and “income splitting” are both phrases deployed by the Treasury and HMRC: they are not presently in common use in the UK in any other context. The practice of married couples setting up businesses together in the form targeted here has been standard since the introduction of the independent taxation of spouses in the late 1980s: it is commonly known as “going into business” and not by the loaded terminology utilised by the consultation paper.

1.3 Historically, income shifting has been achieved through the use of settlements, and the settlements legislation aims to address this. It applies when an individual gains a tax advantage through the use of arrangements in which income is transferred to a spouse or civil partner, but the settlor retains an interest in that income or the underlying property from which the income is derived.

This is a gross misrepresentation of the history of the settlements legislation: it was never intended to capture businesses jointly owned by married couples, and when independent taxation was introduced Parliament took a clear decision not to extend its scope to cover those arrangements.

Indeed, when the independent taxation of spouses was introduced, the then Financial Secretary to the Treasury Norman Lamont stated: “Independent taxation is bound to mean that some couples will transfer assets between them with the result that their total tax bill be reduced. This is an inevitable and



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acceptable consequence of taxing husbands and wives separately.” Parliament voted accordingly to introduce independent taxation, and there was no question of the settlements legislation applying to assets, such as businesses, jointly owned by married couples.

In 2003, with the publication of Tax Bulletin 64, the then Inland Revenue attempted to argue that the settlements legislation did, in fact, extend to jointly-owned businesses. This interpretation, which was never widely accepted by businesses, accountants or other tax professionals outside HMRC and the Treasury, was demonstrated to be incorrect in the House of Lords’ judgment in *Jones v Garnett* in 2007. The Treasury’s attempt to claim that jointly-owned businesses somehow ought to be within the scope of the settlements legislation is highly disingenuous.

1.4 In recent years there has been a growth in the number of small businesses establishing as companies. There are a number of reasons for this. For example, some businesses find that their clients prefer to transact with a corporate body; for others, the limited liability offered by a company is important. Partnerships, too, continue as a common vehicle for small businesses.

1.5 However, the Government recognises that with the continuing growth of small businesses using the corporate or partnership form there are greater opportunities to shift income.

Naturally there are more businesses now than in the past: as the Government is fond of reminding us, the economy has been growing for the last decade and a half. This consultation paper totally fails to demonstrate, however, that the growth in the number of jointly-owned businesses that it claims “shift income” is in any way out of proportion to economic growth as a whole. Unless such a proof can be offered, it cannot be said that there is any new problem that requires new legislation: in the absence of such proof, the new legislation can clearly be said to represent an effort to raise more tax, and not an effort to correct any problem in the tax system.

1.6 Where an individual establishes a business using a company structure, they may decide to introduce another individual as a second shareholder. For small businesses it is common for this individual to be a spouse, partner or other household member of the first individual.

This is an extremely loaded portrayal of family businesses. When spouses establish a business, the decision will usually be taken jointly: it would be unusual for one spouse to take the decision unilaterally, without at least consulting, and more likely gaining the agreement of, the other. Whether or not one spouse will do all or most of the work in the business will not have a bearing on this: going into business is a serious decision that generally requires the agreement and acceptance of both spouses.

It is wrong therefore to depict businesses as being established unilaterally by one spouse, who then “introduces” another shareholder: this is not how married couples generally operate. Taking the circumstances of *Jones v Garnett* as an example, Mr and Mrs Jones visited their accountant to discuss their options together, having previously decided, as a couple, that Mr Jones would begin to provide services as an IT consultant on a commercial basis and that Mrs Jones would support him in this.

[1.6 contd] There are often legitimate commercial reasons for doing this, for example where the second individual contributes labour or capital to the business. In these situations the Government believes that it is right for the distributions from the company to reflect the contribution that both individuals have made.

The consultation paper is correct to say that there are often sound commercial reasons for businesses to be established jointly, but takes an overly narrow view of business relationships. Married couples set up



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their businesses jointly because that is how married couples behave. It is wholly unreasonable to expect spouses to enter into purely commercial arrangements with one another, and by so doing ignore the fact that they are married.

1.7 However, in some cases, the second individual plays either no role or only a minimal role in the business, with the first individual solely or mainly responsible for the activity of the business and for the generation of the income that is then distributed.

This scenario, whereby one spouse has no or minimal involvement in the business, is unusual: with a small business operating (often) from premises in the home, and generating the income on which the entire household depends, it is difficult to imagine a situation in which a spouse would be wholly removed from the day-to-day running of the business.

Married couples will typically develop an informal *modus operandi* between them: this might entail one spouse providing secretarial or similar support while the other undertakes fee-earning work, or one providing support by running the family home and undertaking ad hoc administrative assistance, or one of many other possible permutations. Given that both spouses are reliant on the income generated by the business - if one had a significant separate income, their tax allowance would be used up by that and no tax saving would arise - it is plainly a nonsense to reach any conclusion other than that those two people are in business together, irrespective of the fine details of their working lives.

But this is not relevant: when a business distributes profits to its owners, they are a reward for taking risk. There is, after all, no guarantee that the business will prosper: not even the consultation paper attempts to deny that the businesses in question undertake commercial transactions in order to generate revenue, and commercial transactions carry with them inherent risk. As we have seen, irrespective of the details of who does what in the business, both spouses caught by the proposed new legislation are equally exposed to the risk of the failure of the business; the Government apparently considers that they are not entitled to an equal share in the rewards - if there are any.

[1.7 contd] Regardless of this, it is possible for the two individuals to arrange the distribution of salary and dividends from the company to gain a tax advantage, by the first individual forgoing income that can then be distributed to the second individual and taxed at a lower rate as a result. In these situations the Government considers that income has been shifted from the first individual to the second.

This passage gets to the heart of the conceptual error that underpins the proposed legislation. It assumes that in a situation where fees paid to a business have been generated by the labour of one person, all the profits of the business represent the “income” of that person. This is plainly false, as is explained in Section 3 of PCG’s main response.

1.9 Box 1.1 gives examples of these two scenarios and the tax advantage that may arise through this shifting of income. It is important to note that for demonstration purposes these examples are simplistic. In reality small business arrangements may be more complex.

This acknowledgement that small business arrangements are, in reality, often complex, identifies the key practical objection to these proposals: they will be appallingly difficult to apply to a real-world scenario, to the point where business owners will be unable to self-assess their tax liability with any certainty.

If the Government is unable to provide a realistic example to illustrate the principles it is seeking to describe, how can it possibly expect real business owners to apply those principles to their own tax affairs?



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The detail of the example demonstrates many of the problems already set out: it takes no account of Nina and Charlie's status as a married couple, and does not acknowledge that Charlie is reliant on the income generated by the business he owns jointly with Nina; as such, he is exposed to the risk of the business failing and, in accepting that, should be entitled to share in the rewards that, in this example, it creates. It also repeats the assumption that all the profits of the business would flow to the person whose labour generated them: as is shown in PCG's main response, this is not a sound assumption to make of any business, and denies the very essence of being in business.

Additionally, PCG understands that the example is intended to deal with "profits after tax" for simplicity. It is regrettable that this is not explicitly stated, as the absence of Corporation Tax from the reckoning has seemed to many commentators to be a mistake.

1.10 The Government recognises that, in reality, the contributions of individuals to the running of a small business may not be as simple as in the examples above and therefore that it may be more difficult to establish whether income shifting has or has not occurred. For example, where businesses are jointly owned within a family, individuals' roles or personal circumstances may change over time, affecting their contribution to the business.

1.11 The Government is therefore keen to ensure that, in meeting its objective to provide a fair tax system by removing the tax advantage gained from income shifting, it takes account of the realities of running a business.

Contrary to these two paragraphs, the draft legislation does not so much "take account of the realities of running a business" as blithely ignore them. The realities of running a business, particularly where it is being run by a married couple who may well develop an informal *modus operandi* between them, make it impossible to apply the legislation with any certainty, as discussed above in Section 1 of PCG's main response.

1.12 As described above, current business structures have presented opportunities to shift income in order to gain a tax advantage. The *Jones v Garnett* case looked in detail at one such situation. In this case, which considered the distributions made to the joint owners of Arctic Systems Ltd, HM Revenue and Customs (HMRC) sought to apply the settlements legislation to deem the dividends received by one shareholder as those of the other shareholder for income tax purposes. HMRC lost this case in the House of Lords.

1.13 Following the House of Lords decision, it is now clear that the settlements legislation is not sufficient to address all cases of income shifting. 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.

This account of the Arctic Systems case is partial, in both senses of the word. It ignores the fact that, prior to the publication of Tax Bulletin 64 in 2003 and the Inland Revenue's subsequent attempts at enforcement, it was not generally considered that the settlements legislation could be applied to companies jointly-owned in this way. PCG accepts that a handful of tax offices did apply the settlements legislation in this way, but they were shown by the House of Lords to have been in error, as well as acting contrary to the prevailing understanding of the law.

The claim that the proposed new legislation will give clarity to businesses and their advisers is also, at best, misguided: as we have seen, the new rules will create massive uncertainty. Thanks to the House of Lords' judgment in *Jones v Garnett*, there is currently clarity around this area of law, and if the Government was committed to maintaining a clear tax system it would not disturb this situation.



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PCG is also alarmed to see reference to “clear and modern” legislation: while it is obvious that the proposals will not result in clarity, the criterion “modern” is essentially meaningless and does not in any way offer an appropriate justification for the proposals.

1.14 The intended outcome of the proposed legislation is to undo the tax advantage gained by income shifting arrangements. The legislation does not consider any situations where an arrangement has been made on a commercial or arm’s length basis.

This section again makes the error of condemning arrangements for not being commercial, even though no reasonable person would expect a married couple to enter into purely commercial arrangements with one another. It must be remembered, however, that when a business sells a service or product it does so on a commercial basis: all the money generated by the transaction is generated on a commercial basis.



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2. Comment on the draft legislation and draft guidance

2.1 Analysis of the draft legislation

681B Income-shifting

(1) This Chapter applies where income is shifted from one individual (“Individual 1”) to another (“Individual 2”).

PCG regards the term “income shifting” as both loaded and conceptually illegitimate, and condemns its adoption into law.

- (3) Condition A is that Individual 1—
- (a) is a party to relevant arrangements, or
 - (b) has the power to control or influence relevant arrangements.

This is an extremely vague condition: a shareholder or partner does not need to be a majority shareholder or to have a stronger position than other partners in order to “influence” an arrangement - that can be done simply by talking, which in the case of family members it is fair to assume any relative can do to the other. The same point applies to 681B(5):

(5) Condition C is that Individual 1 has the power to control or influence the amount of the shifted income.

681E Meaning of “relevant arrangements”

(1) For the purposes of this Chapter arrangements are “relevant arrangements” if—

- (a) the arrangements are not genuine commercial arrangements, and

It is at this point in the legislation, in conjunction with 681E(5), that families are penalised for entering into arrangements on the basis that they are related, instead of on a purely “commercial” basis, even though for them to enter into purely commercial arrangements would be ridiculous.

(b) 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.

This is a highly contentious clause and PCG will be interested to see how the courts approach it.

As drafted, this purposive test is ineffective: it is so broad that, so long as a “non-commercial” arrangement seems like it might have been partly motivated by avoidance to a tax inspector, it is within scope of the legislation. HMRC’s officers are notoriously aggressive when investigating small businesses, and lacking in commercial understanding: it seems highly likely that most will see avoidance motivations in many places where none, in fact, existed. But because the clause is drafted so broadly, no court or tribunal will be able to overturn the inspector’s view: the usual application of the “reasonableness” test will not permit it.

In many cases the facts will be totally inconclusive: it might be equally reasonable to infer that there was an avoidance motive, or to infer that there was not. In such cases, HMRC will be entitled to proceed on the basis that the arrangements are caught. This gives the lie to the assertions in the consultation document (paragraphs B7 and B10) that circumstances where there was no intention to avoid tax will not be caught.



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Paragraph B23 of the consultation paper exacerbates this: it states that the purpose of any one participant can be taken to be a purpose of the arrangements. This would further stack the cards in favour of HMRC and against the taxpayer, as it would only have to seem as though one of the parties intended to avoid tax, and under 681E(1)(b) the arrangements are caught. It is, however, not at all clear that 681E(1)(b) actually has the meaning suggested in B23; once again, HMRC's guidance seems not to be supported by the law as written.

PCG understands that HMRC takes the view that, where there has been "income shifting" it is acceptable to presume that it was driven by a tax avoidance motive: the very fact of all the other conditions being met will mean that the purposive test is met as well.

The test must either be tightened, so that it only applies where there is demonstrable evidence of an avoidance motive on the part of both individuals, or removed altogether - it is redundant. It is telling that none of the draft examples mentions the purposive test: HMRC clearly does not intend it to be meaningful.

In 2007, when considering the Managed Service Companies legislation, HMRC and the Treasury were, PCG understands, advised by the Parliamentary draftsman that a purposive test was not useful or meaningful in statute: it is impossible, after all, to say with any certainty what someone was thinking at a given point. If it was not appropriate for the MSC rules, it cannot be appropriate here either; alternatively, it should not have been dismissed so lightly in the context of MSCs.

Overall, as drafted, this clause relies on it being reasonable to infer that avoidance was a motive or partial motive for establishing the arrangement. In conjunction with 681F(b), this strikes PCG as giving HMRC the go-ahead to tax by feel. This cannot be acceptable in a self-assessment system in principle. In practice it is particularly worrying given HMRC's proven track record of treating legitimate businesses with suspicion and investigating them with a total lack of commercial understanding, for instance with regard to IR35.

(4) Condition B is that, if the trade or business consists of making investments, managing them or making and managing them—
(a) the person by whom it is done, and
(b) the person for whom it is done,
are persons not connected with each other who are dealing at arm's length.

PCG understands that this clause will not apply to most businesses, and that therefore in most cases the criteria for "commercial arrangements" will be 681E(3) and 681E(5) only.

However, where this clause does apply, its effects could be serious: it will be impossible for any investment business to invest money on behalf of relatives of the owners, even though such an arrangement could be entered into on a purely commercial basis.

(5) Condition C is that the arrangements are not—
(a) on terms other than those that would have been made between persons not connected with each other dealing at arm's length,
or
(b) such as would not have been entered into between such persons so dealing.

This is the key discriminatory clause in the legislation: it is this clause that seeks to distinguish between family businesses on the one hand, and "commercial" setups on the other. As noted in section 3(ii) of PCG's main response, it is wholly unreasonable to expect a husband and wife, or other relative, to contract with one another on wholly commercial terms.



In fact, any business distributing profits on terms that are not demonstrably 100% “commercial” will be caught by this: this need not cover just family businesses, but ordinary businesses where profits are distributed in a way that does not precisely reflect contributions made by each recipient; this could be done out of courtesy or for any number of entirely legitimate reasons.

681F Meaning of “forgoes income”

For the purposes of this Chapter Individual 1 “forgoes income” if—

- (a) Individual 1 is (or apart from the relevant arrangements would be) entitled to receive the income but does not receive it, or
- (b) having regard to any work done by Individual 1 and all other relevant circumstances, Individual 1 might reasonably be expected to receive the income but does not do so.”

This section deals with the issue of whether someone could “reasonably be expected” to receive income “having regard to any work done by” them. As has been seen, it is not the norm with businesses that profits are distributed to the worker whose labour generated the fees from which the profit arose.

2.2 Analysis of the Draft Guidance

The proposals entail two pages of legislation and eighteen pages of guidance. PCG condemns this approach of passing broad legislation and then using guidance to refine it: it creates gross uncertainty for businesses, and is fundamentally unconstitutional. Courts and tribunals give no regard to HMRC’s guidance: they interpret the law as passed by Parliament. The sad history of the Arctic Systems case demonstrates this amply: HMRC’s guidance did not tally with the law as passed by Parliament.

PCG has some sympathy with the view that the draft guidance is, if anything, too extensive: such detailed examples will encourage businesses to look for the one that they perceive matches their circumstances, which could lead to mistakes in self-assessment if the match is imprecise; more generally, the examples are overly simple and do not provide a useful guide anyway.

Whether the guidance is extensive, as at present, or more simple and principles-led, PCG feels that the exercise will be largely futile: the very nature of the legislation makes it impossible to apply to any given real-world situation with any confidence, and businesses will always be deeply unsure about whether or not they have succeeded, guidance or no guidance.

B.3 The principle underpinning this legislation is straightforward. It starts from the proposition that income tax is intended to be a tax on income. Generally speaking, the charge on individuals is based on the income, profits or other amounts that individuals are entitled to receive.

This is not a straightforward proposition at all: income tax may be a tax on income, but this measure seeks to bring income into charge, or exclude it from being in charge, depending on its origin. This paragraph is another example of the highly loaded presentation by the Government of its case, and illustrates again the inherent unfairness of the proposals.

B.4 However, in some circumstances individuals are able to divert the income that they would have been entitled to receive to someone else. Where this occurs, the primary reason for this diversion may be to reduce the overall amount of income tax payable, typically by taking advantage of someone else’s personal allowances and lower tax bands.



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Where married couples share the rewards from a business, it is because that is how married couples behave. To portray this wholly reasonable and normal behaviour as some sort of dishonest tax fiddle is an insult.

B.5 In these circumstances, the legislation is intended to counteract the tax advantages obtained by the diversion of income to other persons. The legislation describes the diversion of income from one person to another as “income shifting”.

Elsewhere, the consultation paper suggests that such practices are generally known as “income shifting”; here, the Government at least acknowledges that this term is one that it has imagined and then applied to this behaviour, and not any generally-accepted or legitimate term.

B.7 In general terms, the legislation would not apply to genuine commercial arrangements, or arrangements that are the same as those that would have been entered into in dealing with an unconnected party on an arm’s length basis. In addition, the legislation would not apply where:

gaining a tax advantage is not the main or one of the main purposes of the arrangements;

It is clearly not the case that this legislation will not apply where “gaining a tax advantage is not... one of the main purposes”: the analysis above shows that the purposive test at 681E(1)(b) of the legislation is worthless. Where married couples have genuinely entered into arrangements to own a business jointly because they were married, and not primarily to make a tax saving, does HMRC really expect the courts to throw all of its cases out on the basis of 681E(1)(b)? Of course not: the purposive test is meaningless - if it is not, HMRC will be able to apply this legislation to relatively few cases, which is clearly not the intention.

B.31 On the basis that individual 1 has undertaken all of the work in the partnership and generated all of the profits, it would be reasonable to expect individual 1 to receive all of the profits from the partnership including the share of profits paid to individual 2.

Why would it be reasonable to expect Individual 1 to receive all the profits? In ordinary businesses, it would be wholly unreasonable to expect profits to flow automatically to the person whose labour generated them: if Individual 1 had been an employee of a large consultancy, and the consultancy had made £60,000 profits, after expenses, as a result of his labour, would Individual 1 expect to receive those profits? Of course, he would not. Why, then, should a different rule apply just because Individual 1 happens to own the consultancy himself, jointly with one other person?

B.45 The income shifting legislation does not mean that businesses will have to maintain any additional records.

This is an outrageous statement: it is clear that many businesses will have to keep many new records in order to comply with the legislation.

[B45 contd.] In the vast majority of cases it should be clear from the existing business records, other documents and/or agreements whether the new legislation applies or not.

This is plainly not the case: small family businesses do not generally keep timesheets showing the contribution of each individual to the business, nor do they assess “market rates” for given types of work and then seek to pay the appropriate “market rate”. Most rely on informal ways of working that develop over time, often relying on trust that would not be extended to unrelated workers.



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[B45 contd.] Broadly speaking, the new legislation will only apply to those individuals who have taken deliberate steps to shift their income for the purposes of gaining a tax advantage.

This airy generalisation is an insult to the tens of thousands of family businesses who will be affected by this legislation and who in no way sought to enter into any dishonest or anti-competitive behaviour when establishing themselves, but who instead acted in a way that is simply the norm. As has been demonstrated, the new legislation will apply to all manner of arrangements, regardless of whether they were motivated by tax considerations or not.

B.46 Where income shifting has taken place, individual 1 and individual 2 will need to record the details on their respective self-assessment tax returns. The normal self assessment record requirements apply and the individuals should keep sufficient records to support any entry on their tax returns.

The second sentence above immediately gives the lie to the opening assertion of the previous paragraph.

B.48 HM Revenue & Customs (HMRC) expects individuals, together with their advisers, to use their own judgement in working out the level of shifted income. In doing so, they must adopt a reasonable basis for any conclusions reached.

This paragraph hits on an interesting point: tax, like any enforcement system, must be essentially self-policing. Taxpayers and their advisers must be able to work out what is owed, and pay it, without any difficulty. HMRC does not have the resources to check every tax return and then enter into a dispute with every taxpayer who has made an error or who has reached a valid conclusion which HMRC does not recognise as such.

Taxpayers and their advisers will simply be unable to meet their obligations in this way under the current proposals.

B.50 Those in the business are in the best position to assess the duties and work done by individual 2. The work carried out may often be a significant consideration, particularly in situations involving businesses that have little or no capital or assets and rely heavily on individual 1 to generate the income of that business.

Paragraph 1.7 of the consultation paper refers to circumstances in which Individual 2 has “either no role or only a minimal role in the business”: that section of the consultation document, which seeks to offer a justification for the new measure, makes no mention of scenarios in which Individual 2’s role represents “a significant consideration”. Here, by contrast, the reader is presented with exactly this scenario, even though the idea of “income shifting” involving someone who makes a meaningful contribution to the business has not previously appeared.

This reinforces PCG’s impression that the Government has attempted to justify this measure in an unfair and unbalanced way, and in formulating it has ignored the reality of many family businesses.

B.51 Second, it might be appropriate to consider the amount of capital that individual 2 has invested in the business. For example, considering whether individual 2 has contributed capital in the business, including the source of any capital contributed or lent, which may warrant a particular level of return, might be a way of assessing their value (or part of their value) to the business.

This seems to suggest that small business owners will be expected to monitor the fortunes of investments they have not made, in order to justify their self-assessment. No precise indication is given of what



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comparator might be acceptable for ascertaining what level of return a given amount of capital might have generated if invested elsewhere.

B.52 A third question might be about the extent to which individual 2 takes on risk relating to the business and, as such, the extent to which this is rewarded through remuneration. This might include using a personal asset (including a jointly owned one such as a house) as collateral for a business loan. The risks that should be considered are ones that arise on a commercial basis.

This mention of risk is long-overdue in the consultation document. It is not clear from this, or the guidance, however, how much profit a business owner is entitled to receive by virtue of having used, for instance, the family home as security for a business loan. This arrangement is a common one for freelancers, particularly when starting out, yet the guidance cannot tell them how much reward they are entitled to for risking their homes.

Indeed, this is one example of how the legislation is likely to lead to perverse behaviours: if it is financially advantageous to secure a business loan on a home, even if the loan is not really needed, many businesses may give serious consideration to doing so.

B.53 These questions are not intended to be an exhaustive list of the factors to be considered [...]

This rather begs the question of how taxpayers are expected to self-assess their tax liabilities when guidance on how to go about doing so remains incomplete. Given that the consultation paper speaks of bringing “certainty”, it is simply not adequate to present a vague assurance that these notes “should be relevant in one permutation or another in most cases.”

2.3 Analysis of the Draft Examples

Generally the examples exhibit the same problems as the rest of the consultation document and guidance: they rest on a fundamental conceptual misunderstanding; they take no account of the realities of business; they make arbitrary assumptions. A few key examples will be picked out, but PCG cannot see any way of offering constructive advice to improve guidance on legislation that is so fundamentally misconceived and ill-defined: no amount of guidance can clarify it.

Example 5

Trading profits for the year are £70,000, which are split between individual 1 and individual 2 equally, (i.e. each partner receives £35,000). £35,000 is considered an arm’s length return on individual 2’s investment of £200,000.

Why is £35,000 considered an arm’s length return on £200,000, and by whom? This is an arbitrary assumption: unfortunately, real businesses will not have the luxury of being able to make arbitrary assumptions and then expect a tax inspector to agree with them. If no clear mechanism for calculating an “arm’s length” comparator is available, that test should not have a place in the legislation. As it is, this example highlights the extent to which the legislation will introduce further taxation by feel.

B.87 Individual 1 and individual 2 set up a company to exploit the personal services of individual 1,

PCG is struck by the loaded use of vocabulary in this example: the use of the verb “exploit” immediately implies that something dubious or underhand is going on. HMRC and the Treasury have long had difficulty accepting that a business is genuine when it involves only one person, and particularly when that person is providing services: nevertheless, it is clearly possible in law to provide services on a commercial basis, and hundreds of thousands of freelancers do this every day, in just the same way as many large consultancy



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companies do. The Government should recognise this as being in business, and not “exploiting personal services”.

B.90 [...] Trading profits for the year are £40,000 after taking into account salaries of £40,000 for individual 1 and £10,000 for individual 2 (both salaries are at market rates).

PCG is struck by the insouciance of the statement that “both salaries are at market rates”: it is wholly misplaced. Calculating properly comparable market salaries will be extraordinarily difficult, particularly where comparable tradespeople are often self-employed and therefore do not have salaries as such, as is the case with plumbers such as are cited here.

B.102 This example illustrates a scenario that may be covered by the income shifting legislation.[emphasis added]

PCG feels bound to ask: if even the official examples cannot tell for sure whether a given instance is caught or not, what hope does the ordinary taxpayer have? Paragraph B104 indicates that, “where there are other factors that indicate that the arrangements remain commercial, the legislation may not apply.” Where are taxpayers supposed to find information setting out what these “other factors” might be?

When questioned on whether the legislation would apply to a given situation or not, it seems that HMRC is starting to repeat the phrase “it depends on the facts” as a kind of mantra: this demonstrates just how unreasonable it is to expect small businesses to weigh up such nuanced considerations in such close detail in order to assess their tax liabilities - it is such a difficult exercise that many, inevitably, will get it wrong, and those who get it right will have no confidence that this is the case.

With this in mind, it seems likely to PCG that this legislation will damage the relationship between HMRC and the taxpayer still further: as tax inspectors come to develop experience of working with the new legislation, they will inevitably encounter many businesses who have made mistakes when applying it; the culture will grow still further within HMRC whereby it is presumed that taxpayers have got it wrong; investigations will therefore become even more aggressive than at present, as taxpayers are approached as guilty until proven innocent.

B.110 [...] For example, the legislation would not apply when the time off is for maternity or sick leave.

PCG is at a complete loss to understand why, if a co-owner withdraws from an active role in a business for reasons of maternity or sick leave, it should not count as “income shifting” if they continue to receive dividend income or distributions of partnership profits.

There is clear law surrounding the rights of employees to sick pay and maternity entitlements: however, business owners are usually not formally employed by the business; they are, in a meaningful sense, in business, and exposed to all the risks that come with that. This includes having to pay for their own leave, whether for reasons of illness, parenthood or simply taking a holiday.

There is perhaps, at most, a case for saying that in such circumstances the co-owner should be entitled to the statutory rights of employees: indeed, this is something that could be written into the legislation. Yet where there is a clear statutory framework already in place that could quite easily be made applicable, the guidance has instead gone out of its way to obfuscate and complicate: no explanation is offered for why a co-owner should be entitled to receive dividends if ill or pregnant and not generating revenue for the business, but not if they are able-bodied, not expecting a child and not generating revenue for the business.



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This guidance appears to create considerable scope for co-owners to masquerade as being subject to long-term sickness - surely this cannot be the Government's intention?

B.114 This example illustrates that the income shifting **legislation would not be circumvented by the use of a Personal Service Company (PSC)** although the applicability of the legislation will depend on the facts of each individual case.

Just like “income shifting” itself, the term “Personal Service Company” is a fiction imagined for official purposes and has no place in the vocabulary of real business on a day-to-day basis: PCG rejects it utterly. A company is a company; “personal service” is a legal characteristic of employment; the term “Personal Service Company” implies that there is something improper about the company, and that it is being used for something other than commercial purposes. It is not acceptable to besmirch the many small companies in the UK with this label.

Were it not for the appearance of the term in this example, PCG would have been in the happy position of being able to congratulate the Government for taking heed of our previous complaints about this term and refraining from its use.



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3. Comment on the draft Impact Assessment

PCG accepts that the Impact Assessment published alongside the draft legislation is a draft on which the Government wishes to consult. It should not necessarily be a problem, therefore, that its estimates of the likely costs of the measure seem to be totally unrealistic.

PCG is gravely concerned, however, that the decision to proceed with this legislation has been taken prior to a full Impact Assessment being conducted: the consultation paper does not seek to consult on whether or not the policy will be taken forward. There is therefore no evidence that a problem exists that must be corrected, and no evidence that the Government's proposed "solution" will bring more benefits than costs.

This legislation therefore represents governmental policy-making at its very worst: decisions have been taken, on the basis of no meaningful evidence, that pre-judge the outcome of the Impact Assessment process.

PCG will demonstrate below that this measure is likely to bring, at best, modest benefits to the Treasury, and at massively disproportionate cost to the taxpayer. We will be writing to the Better Regulation Executive to complain at the conduct of this "consultation" in the strongest possible terms.

Note: in this section, the draft IA will be cited in *italics*.

What is the problem under consideration? Why is government intervention necessary?

The Government believes that an individual should pay tax on income that is attributable to them.

By "income attributable to them" the IA seems to mean "income arising from revenues generated by their labour": this is a radical concept, as many shareholders and partners receive income that is ultimately derived from revenues to a business generated by the labour of other people. In fact, the position that all income should be taxed as the income of the person from whose labour it is derived is plainly a nonsense and it is clear that the Government is not attempting to implement it consistently across the tax system as a whole.

The Jones v Garnett case has highlighted the need for new legislation to provide clarity for business regarding the Government's position.

Once again, this statement does not say what it means. The Government evidently intends to enforce its own position via new legislation. It is dishonest to claim that the judgment by the House of Lords created "the need for new legislation to provide clarity for business regarding the Government's position": the Jones v Garnett case in fact showed that the Government's position was not applicable in law, and did so very clearly. Further clarity in this respect is not required.

What are the policy objectives and the intended effects?

The new legislation should prevent individuals gaining a tax advantage from income shifting through company and partnership distributions. It is not the intention that businesses will change their remuneration structure as a result of the legislation, but rather that any tax advantage derived from non-commercial structures is negated.

If it is not the intention that businesses will change their remuneration structures, the Government must abandon its proposals. Even where there are perfectly valid reasons for current arrangements to be in place, the inevitable fear of a tax inspection in which this extremely complicated set of provisions will be at issue will create an enormous incentive for many businesses to change their structure.

The Government estimates that this would reduce the tax lost through income shifting by £200m and protect further tax loss of £350m by 2010-2011.



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When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

4 years (after receipt of the first self-assessment returns concerned, which will be 2010).

PCG demands to know the basis for these figures and how HMRC proposes to monitor revenues generated by this measure to justify them. We know from experience of previous taxes, not least IR35, that HMRC is unable to monitor the revenues generated by individual tax measures: to attempt to justify their introduction on the basis of revenues that will never be monitored is dishonest in the extreme.

It is not sufficient to say that the policy will be reviewed after four years: it must be made clear how this review will be undertaken, although PCG suspects that it cannot be done so with any meaningful reference to the figures quoted here. PCG would also like confirmation of when that four-year period begins: in 2008, or 2010? The text as drafted is susceptible of both interpretations.

PCG has previously protested about the use of such meaningless figures to justify new tax proposals and is deeply disappointed to see this disreputable practice continued here.

The cost-benefit analysis in the IA is also inadequate. Despite the acknowledgement in the draft guidance that businesses will have to keep new records in order to demonstrate their compliance with the new legislation, the average annual cost to business is shown at zero. Clearly this takes its cues from the bizarre suggestion elsewhere in the guidance that no new records will be required. The final IA must remedy this egregious failure.

The comparison with IR35 is also illuminating in other respects. The maximum tax saving possible through “income shifting” is between £6,000 and £7,000 per person per year. The maximum tax demand under the legislation, even using discovery powers to go back six years, will be c.£42,000 (and this will obviously not be possible until returns are submitted for the 2012-14 tax year). These are relatively small sums for HMRC to pursue: they are certainly smaller than the potential liabilities under IR35, where the tax at stake has been known hit six figure sums for even a three-year contract.

Other key non-monetised benefits by ‘main affected groups’ - Taxpayers in general will benefit from those who formerly shifted their income bearing the tax burden applicable to their income.

The IA does not explain how this benefit will be felt by taxpayers generally. Logically, this can only be felt by cutting taxes by the equivalent amount to the new revenue supposedly generated, but the IA does not state which taxes will be cut, or by how much.

Key Assumptions/Sensitivities/Risks

The overall scale of income shifting activity and the behavioural response to the legislation among small businesses is difficult to gauge accurately.

This is an extraordinary admission: if the Government cannot gauge the extent of the behaviour whose effects it wishes to nullify, how on earth can it justify taking any action?

What is the total annual cost of enforcement for these organisations? £ Negligible

PCG understands that this question is intended to be viewed in terms of new buildings, infrastructure or procedures that might be required: as none is envisaged for the FBT, the answer of “negligible” new costs has been arrived at. Even with this in mind, however, PCG would like to see a more thorough appraisal of HMRC’s likely costs overall as a result of this measure.



The new regulations are undeniably complex: they place a great reliance on subjective judgments to determine what arrangements are caught and how the legislation should be applied; inevitably, any investigation under the new rules will therefore be extremely time-consuming for HMRC. It is clear that this legislation cannot be enforced cheaply: these increased costs must be shown in the IA.

Elsewhere the IA states that “HMRC will develop a compliance strategy in line with any legislation to ensure its effectiveness”: developing and enforcing such a strategy surely cannot be a “negligible” cost.

Does enforcement comply with Hampton principles? Yes

The proposals do not comply with the Hampton Principles, contrary to this unexplained assertion. The Hampton Principles state: “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.” As we have seen, this legislation will act as a significant impediment to economic progress, by imposing significant cost burdens on existing businesses, providing a disincentive to people considering starting up any new business involving more than one person and possibly encouraging existing business owners to shut down their businesses, end their business careers and seek permanent employment instead.

Costs: The current losses of income tax are likely to increase, leaving those who do not shift their tax burden paying a disproportionate share of tax. Moderate estimates have been provided given the complexities of measuring the numbers of businesses involved, but it is assumed that the number of businesses that would engage in income shifting could increase following the loss of the Jones v Garnett case. This is an unacceptable risk to the Exchequer.

The “losses” of income tax spoken of here are illusory: the tax that the new legislation seeks to capture is tax that is not currently owed in law; it cannot in any sense be said to have been “lost” to the Exchequer - it was never owed.

The IA provides no evidence in support of its assertion that “the current losses [sic] of income tax are likely to increase”.

The assertion that “it is assumed that the number of businesses that would engage in income shifting could increase following the loss of the Jones v Garnett case” is, at best, meaningless: even if one takes this statement at face value, the numbers could go up, or they could go down, or they could remain the same. No argument or evidence for any such proposition is put forward.

In fact, the Jones v Garnett case did nothing other than confirm the generally-accepted status quo since the independent taxation of spouses was introduced in 1988. Since that time it has been standard practice for business advisers to suggest that businesses be set up jointly by married couples: this does not constitute “income shifting” but is rather an example of perfectly normal and rational behaviour by married couples. As nothing has changed, there is no reason to suppose that such behaviour would become any more or any less prevalent.

*Option 2: Amendments to existing settlements legislation
[...] It is expected that a significant additional HM Revenue & Customs (HMRC) resource would be required, drawing resources from other compliance work.*

How can it be said that extra HMRC resources would be needed to police an updated version of the settlements legislation, but not to police the new “income shifting” legislation, as is suggested elsewhere in the IA? This cannot possibly be correct.

Option 3: New legislation specifically written to address income shifting



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[...] Costs: New legislation would not necessarily have the support of existing case law or guidance. For it to be successful the legislation would have to be workable and HMRC would have to provide clear guidance on its practical applications.

This paragraph should set out more clearly that there will inevitably be a period during which case law will become established around the new legislation. This will entail significant cost to business: the businesses caught up in the test cases will have professional fees, as will HMRC, to say nothing of HMRC staff resources deployed on them; other businesses will refrain from making investment and other decisions pending the outcome of test cases, or might take and execute decisions only for subsequent developments to prove them unwise. All these costs must be estimated and added into the reckoning of the IA.

This paragraph also assumes that clear guidance can be provided on the practical application of the new legislation: as PCG has sought to show, this is highly doubtful, as the legislation is fundamentally unclear.

Analysis of the data has identified 65,000 companies where income shifting is likely to be taking place.

PCG would be extremely interested to know how this figure was arrived at. It seems very low. PCG has used surveys of its own membership to measure the proportion of companies with one fee-earner but two or more people working for the company - broadly the kind of structure targeted by this measure - and projected this on to the UK business population as a whole: the results suggested that 277,200 companies will be targeted. This is to say nothing of partnerships, for which PCG does not have sufficient data to undertake an equivalent exercise; but it seems reasonable to expect at least similar numbers of partnerships to be at risk. It could well be that over half a million businesses will be within scope.

Accordingly, the estimates of revenue arising from the measure will also be wrong, although PCG has elsewhere noted its scepticism regarding the meaningfulness of such estimates anyway.

The Government currently does not believe that there will be a decreased administrative burden on existing companies, as it is unlikely that those companies currently income shifting will dissolve purely on the basis of the legislation. If any individuals did dissolve their companies to revert to sole trader form, it is estimated that they also would reduce their administrative burden.

It seems unlikely that many limited companies will be dissolved as a result of this legislation: they are used for business purposes for a multitude of reasons, such as limited liability and the ability to find assignments via recruitment agencies; these commercial reasons will remain.

The exception to this will be for businesses where the owners feel they would rather abandon their business careers and seek to return to employment: few people are likely to take this decision purely because they will be paying more tax, but many may feel that contending with the vagaries of the legislation and facing an increased and ever-present threat of an aggressive tax investigation mean that being in business is simply not worth it. Freelancers will find it easier than most to shut down their business operations, as they generally will not have to dispose of dedicated premises or significant capital assets: accordingly, there is a serious risk that these proposals will lead to a decline in labour market flexibility.

Among those who do remain in business, it may be that many jointly-owned companies will change the structure of their shareholding so that they are owned exclusively by one person: this will avoid any protracted battle with tax inspectors over the application of the new legislation. It will also deny those spouses who are equally exposed to the risk of a business failing the right to an equal share in the rewards if it succeeds.



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All those business who are income shifting will face a one off cost in assessing the impact of the legislation.

This is inaccurate: many businesses who are not caught by the legislation will also have to assess their position. The legislation is so broad that many who are not caught may believe that they are, or alternatively may feel that they are probably not but dare not risk taking no action, and seek to change their arrangements anyway.

Moreover, it is wrong to assert that this cost will be a one-off: as the draft guidance sporadically acknowledges, businesses' circumstances change regularly and many will be obliged to keep checking and re-checking whether they have moved into or out of the scope of the legislation.