

# Guide to the Family Business Tax on "income shifting"

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*Following the Government's defeat in the Arctic Systems case in 2007, it has decided to introduce legislation to prevent people who own businesses jointly from sharing the profits in the traditional way. From April 6th 2008, income tax must be paid on profits without regard to the ownership split within the business.*

## Who is caught by the proposals?

Only profit distributions by partnerships and dividends from companies are caught: no other forms of payment are within scope.

The legislation applies where there is an income tax saving arising from a dividend or profit distribution: even if a payment is theoretically within the scope of the legislation (see Box), if no tax has been saved, you do not need to apply the legislation.

The legislation does not rely on a "connected persons" test: if you share profits with anyone in what HMRC views as a "non-commercial" way, you could be caught – often this may well be a relative, but it doesn't have to be.

Remember that the payment of the dividend or profit share is the point at which the legislation bites: it is necessary to consider applying the legislation to any such payments made from April 6th 2008, irrespective of when the profits themselves were accumulated.

## What do I need to do to stay outside the legislation?

Unlike with IR35, it is not clear what will take people outside the legislation and what won't – it will take several years to build up some case law around this issue.

Essentially, you need to justify any part of a dividend or profit distribution that is taxed more favourably by virtue of going to a shareholder or partner of the business (Individual 2) who is not the main fee-earner (Individual 1).

Remember that you only have to justify enough of a dividend to use up Individual 2's lower rate band: beyond that point, there will be no tax

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advantage, so the legislation will not apply.

You should keep records of all contributions made to the business by all shareholders or partners, including work done, investments made, ideas and advice contributed etc.

More problematically, you must also place a value on all of these contributions, with a comparison to what you would have paid a third party to provide them. Where business advice is concerned, for example, this price could actually be very high!

If the value of these contributions is higher than the amount of a profit share that would use up Individual 2's lower rate band, you will be able to make the payment to Individual 2 without any additional tax hit.

If the value of these contributions is less than the amount of a profit share that would use up Individual 2's lower rate band, you will be deemed to be "shifting income" to Individual 2 and may wish to consider whether Individual 2 could make any further contributions to the business.

But you must be rigorous in making this assessment: provide documentary support for every valuation of every contribution; do not overestimate the value of each person's contribution simply to get around the legislation – if HMRC investigate your affairs, they will be able to use it as a stick to beat you with.

## What advice does PCG offer?

It is an extremely good idea to have insurance in place to cover the costs of an investigation under these rules: because the legislation is so subjective, any enquiry by HMRC is likely to be lengthy, distressing and expensive. The Professional Expenses Insurance that is

bundled with PCG membership will pay your fees for an investigation under this legislation.

PCG has published an extensive guide to the legislation, available exclusively to members from [www.pcg.org.uk](http://www.pcg.org.uk); a more thorough exploration of the legislation can be found within it.

## How the legislation "works" – a heavy paraphrase

In the draft legislation, profits distributed to "Individual 2" must be taxed as the income of "Individual 1" if four conditions are met:

- A) Individual 1 is party to the relevant arrangements, or can control or influence them
- B) As part of these arrangements, Individual 1 "forfeits income" and that income flows to Individual 2
- C) Individual 1 can control or influence the amount of "shifted income"
- D) The income is made up of dividends from a company or profits of a partnership.

## The arrangements are "relevant arrangements" if:

- 1) they are not "genuine commercial arrangements"
- 2) they seem to be motivated by tax avoidance

## "Commercial arrangements" means:

- A) they are undertaken for reasons of a business
- B) if the business is an investment business, the arrangements are not between connected persons
- C) they are what unconnected parties dealing at arm's length would have agreed to.

It is Individual 1's responsibility to put the income on their self-assessment return, and ensure that Individual 2 knows about it and does not put it on theirs as well.

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