

GUIDE TO THE FAMILY BUSINESS TAX ON “INCOME SHIFTING”

for freelance consultants and contractors

Edition 1.0

Published February 2008

This guide provides a comprehensive overview of the Family Business Tax proposals, known as legislation on “income shifting”. The proposals, which stem from the Government’s defeat in the Arctic Systems case in 2007, would introduce legislation to prevent people who own businesses jointly from sharing the profits in the traditional way.

This guide should not be taken as acceptance of HMRC’s view; rather, as the representative body for freelancers, PCG wishes to ensure that its members are fully advised about what this legislation will mean for them.



PCG members are a diverse group of freelance consultants and contractors who represent a wide range of disciplines and market sectors throughout the UK.

Guide to the Family Business Tax legislation on “income shifting”

TABLE OF CONTENTS

Introduction	2
Disclaimer	2
Version	
SECTION ONE: ARCTIC SYSTEMS AND THE SETTLEMENTS LEGISLATION	3
1.1 Background	3
1.2 Arctic Systems: the basis of the House of Lords’ Judgment	3
1.3 Government’s Response	5
1.4 Settlements Legislation	5
SECTION TWO: THE FAMILY BUSINESS TAX	7
2.1 Government Proposals on “income shifting”	7
2.2 “Income shifting” within modern businesses	7
2.3 Outline of the proposed legislation	9
SECTION THREE: PRACTICAL ISSUES	15
3.1 Record keeping	15
3.2 How the legislation might be applied in practice	19
3.3 Can I re-arrange my affairs to take myself outside of the legislation? Should I?	21
3.4 “income shifting” FAQs	21
APPENDIX A: DRAFT LEGISLATION, DECEMBER 2007	26
APPENDIX B: DRAFT EXAMPLES FROM THE CONSULTATION PAPER	29

Guide to the Family Business Tax legislation on “income shifting”

Introduction

This guide has been written on the basis of HMRC’s December 2007 Consultation document “Income Shifting: a consultation on draft legislation”. It is possible that the legislation published in this document will be amended prior to its inclusion in the Budget, and that it may be amended further while the Finance Bill is going through Parliament. The December legislation can, however, be viewed in full in Appendix A to this guide.

Given that the legislation will come into force on April 6th 2008, PCG feels that it is important to offer its members some indication of how they might wish to respond - although it would be unwise to act without seeking bespoke professional advice.

PCG has been lobbying hard against these proposals, and will continue to do so until the parliamentary stages of the Finance Bill are over. However, there is every indication that the Government’s position is entrenched, and that this measure will be included - in some form or other - in the Budget. Budgets are matters of confidence for any government, and once the proposals are in the Budget it will therefore not be defeated by votes in Parliament, and is certain to become law.

Whilst there is considerable commentary within this guide, we have also reproduced where appropriate much of the Consultation Paper’s content in order to help members understand the Government’s thinking in this area (these sections are in *italics*).

We have included all the examples in Appendix B for a secondary reason - it will become very clear to the reader that identifying extreme examples of what is, and what is not, “income shifting” is a relatively easy matter. Where an individual will sit in the huge swathe of grey area in between is less easy to establish and we feel that members will no doubt be able to identify with some of these examples and will need to consider the implications for their own tax affairs.

This should not be taken as acceptance of HMRC’s view, merely that one needs to understand the Government’s thinking in order to understand how you will need to deal with them.

Disclaimer

This guide does **not** constitute legal advice and neither PCG nor any contributor to the guide may be held responsible for any consequences of actions taken as a result of reading it. PCG’s advice is that freelancers should use their judgment to decide whether or not they feel competent to arrive at decisions on these matters and, if they do not, to seek professional advice on an individual basis.

Version

This is Version 1.0 of the guide, published in February 2008. Check www.pcg.org.uk for further updates, particularly during 2008, when the consequences of the legislation are likely to become clearer over the course of the year.

This guide was prepared for PCG by Abbey Tax Protection.

Guide to the Family Business Tax legislation on “income shifting”

SECTION ONE: ARCTIC SYSTEMS AND THE SETTLEMENTS LEGISLATION

1.1 Background

In recent years the number of small businesses being established as companies has grown. In fact, it actually became more attractive to do so when the Government set a 0% starting rate for Corporation Tax on the first £10,000 of profit in 2002 although the 0% starting rate was subsequently withdrawn in 2006. As such, it could be argued that it was the Government which had actively encouraged the use of this vehicle! There are also significant numbers of businesses trading as partnerships. Indeed, the use of the limited company is prevalent in the freelancer market in many sectors, owing to the need to use a corporate form in order to find contracts via agencies.

However, the Government has long been concerned that both limited companies and partnerships offer the opportunity to ‘shift’ income, or if we use less emotive language, to share profits between the directors and partners. Such “income shifting” had been seen by the accountancy profession for many years as a legitimate tax-saving device i.e. dividends were shared equally amongst the directors/shareholders of family (often husband and wife) run companies, or the profits in a partnership were shared equally between the partners (again often these would be family-run business).

HMRC’s argument was that where one spouse or family member was earning all, or the lion’s share, of the income on behalf of the business, he/she should not be able to spread that income across its other proprietors to reduce the overall tax burden. This was especially the case where the amount being allocated to the non-fee-earner was deemed to be a ‘bounteous’ arrangement and the individual was ‘settling’ his income on another family member in order to receive a benefit or justify paying less tax in return.

HMRC believed that the settlements legislation which had been passed before the Second World War was designed to tackle this form of tax avoidance and ‘resurrected’ it when it chose right at the start of this century to tackle a number of small businesses trading as limited companies.

This challenge brought both the accountancy professionals approach to tax planning and HMRC’s settlements legislation into conflict and the two opposing views collided in the much publicised Jones V Garnett or “Arctic Systems” case, focusing on S660A of the settlements legislation.

Much was written at the time as Geoff and Diana Jones of Arctic Systems Ltd, with the backing of PCG and others, took on the might of HMRC. The ebb and flow of the case truly gripped the small business and taxation communities as the case progressed from the local tax office to the Special Commissioners, the High Court, Court of Appeal and ultimately the House of Lords, with both sides losing and successfully appealing along the way.

1.2 Arctic Systems: the basis of the House of Lords’ Judgment

All five Law Lords agreed that there was a “settlement” for the purposes of S660A, but rejected HMRC’s appeal on the basis that it fell within the exemption provided for an outright gift between spouses. The settlements legislation therefore does not apply to companies jointly owned by married couples and civil partners which are structured in this way.

Although Diana Jones bought her share in Arctic Systems, rather than being directly given it by Geoff, the judgment treated the purchase as a gift, on the grounds that it was only possible because Geoff allowed Diana to buy the share. Gifted and purchased shares are therefore both within the scope of the exemption for gifts between spouses.

Guide to the Family Business Tax legislation on “income shifting”

All five Lords therefore disagreed with the Court of Appeal, which had ruled that no settlement had taken place. Lord Hoffman observed: “I cannot agree that this was a “normal commercial transaction between two adults.” It made sense only on the basis that the two adults were married to each other. If Mrs Jones had been a stranger offering her services as a book keeper, it would have been a most abnormal transaction. [...] It was only “natural love and affection” which provided the consideration for the benefit he intended to confer upon his wife. That is sufficient to provide the necessary “element of bounty”.” Having established that a settlement had occurred, however, they also established that it was exempted from the settlements legislation.

The judgment also observed that ordinary shares are not “wholly or substantially a right to income” and are therefore within the scope of the exemption. Lord Hoffman noted: “[Diana Jones’s share] was an ordinary share conferring a right to vote, to participate in the distribution of assets on a winding up, to block a special resolution, to complain under section 459 of the Companies Act 1985. These are all rights over and above the right to income.”

Preference shares would, however, most likely be considered as wholly and substantially a right to income on the basis of the judgment, and not exempted from the settlements legislation, irrespective of whether or not the settlor and settlee are married. Indeed, we are aware that HMRC are actively pursuing enquiries into arrangements involving preference shares.

Overall, perhaps the most concise summary of the judgment could be found in the comments by Lord Hope of Craighead: “For the reasons my noble and learned friends have given, an arrangement by which one spouse uses a private company as a tax-efficient vehicle for distributing to the other income which its business generates is likely to constitute a “settlement” on the other spouse within the meaning of section 660G(1) of the 1988 Act. But so long as the shares from which that income arises are ordinary shares, and not shares carrying contractual rights which are restricted wholly or substantially to a right to income, the settlement will fall within the exception created by section 660A(6).”

The judgment also concluded that establishing a company in the same manner as Arctic Systems was enough to constitute a settlement: it is not necessary to consider later events such as the distribution of dividends in order to conclude that a settlement exists (even if it is exempted from the legislation for other reasons). Lord Walker of Gestingthorpe observed: “The Revenue argued that the arrangement entered into by Mr and Mrs Jones included, but was larger than (and so different from) the establishment of the original corporate set-up under which each had half of the issued share capital of Arctic Systems Ltd. I do not accept that argument. [...] The establishment of the corporate set-up, together with the common intention that Mr and Mrs Jones would use it to minimise tax in accordance with their accountants’ advice, was the essential arrangement. What happened afterwards was that the arrangement was put to its intended use.”

Baroness Hale of Richmond was somewhat reluctant to conclude that a settlement in fact existed, but did not ultimately dissent from that view: “[M]y reservations about the Revenue’s case that this is a settlement at all are very similar to those of the Chancellor: it only becomes a “settlement” within the meaning of section 660A(1) because of expectations about later events which are too uncertain and fluid to be included as part of the initial arrangement. However, in view of our unanimous conclusion that this appeal should be dismissed, it would be presumptuous of me to reach a different conclusion on the settlement point.”

Guide to the Family Business Tax legislation on “income shifting”

Baroness Hale’s comments also included a summary of the history of the taxation of married couples, and an observation that this case has proved extremely complex, and that the numerous parties to have reached judgments on it have tended to vary in their conclusions: “The policies are easy to state. But it is not easy to translate them into statutory language which exactly captures the promoters’ intent. It is some comfort that the professional judges who have so far decided this case have reached such different conclusions and that we have reached different conclusions from them all.”

In summary, of the eleven judges and Commissioners to have reached a judgment in the case, only two agreed with the Revenue (one Special Commissioner and Park J at the High Court), albeit that the various findings in favour of the Joneses were arrived at for diverse reasons.

It is PCG’s advice that PCG members who have established their companies in this way may now wish to take professional advice, particularly if they have paid tax on the basis of being caught by the settlements legislation.

1.3 Government’s Response

The Government’s response was swift and the day after the House of Lords judgment was given, the Exchequer Secretary to the Treasury, Angela Eagle, made a Written Statement to Parliament:

“The Government acknowledges the judgment given by the House of Lords in the Jones v Garnett (Arctic Systems) case. The Government is committed to maintaining fairness in the tax system. The case has brought to light the need for the Government to ensure that there is greater clarity in the law regarding its position on the tax treatment of income splitting.

Some individuals use non commercial arrangements (arrangements that they would not reasonably enter into with an arms-length third party) to divert income (which would, in the absence of those arrangements have flowed to them) to others. That minimises their tax liability, and results in an unfair outcome, increasing the tax burden on other tax payers and putting businesses that compete with these individuals at a competitive disadvantage.

It is the Government’s view that individuals involved in these arrangements should pay tax on what is, in substance, their own income and that the legislation should clearly provide for this. The Government will therefore bring forward proposals for changes to legislation to ensure this is the case. In the meantime, HMRC will apply the law as elucidated by the House of Lords and will be providing guidance in due course.

The Government would not want commercial arrangements to be caught by any change to legislation. Consultation should help to ensure this.”

Before considering the consultation document, it seems sensible to reiterate to readers that the Settlements Legislation is still active and may be relevant to PCG members and owners of small family businesses across the UK.

1.4 Settlements Legislation

Although it might be tempting to think that the Arctic case put paid to the settlements legislation, this is in fact not the case. The settlements legislation still has applications and HMRC are still seeking to enforce it where possible. As stated above, a good example of this is where a company issues preference shares which have no right to anything other than income i.e. the preference shareholder has no voting rights and this no influence over the running of the company.

Guide to the Family Business Tax legislation on “income shifting”

Let us assume for example a family run company where one parent is the main fee or income earner and holds the ordinary shares issued by the company. The spouse and/or children or other family members hold preference shares in the company. At the end of the year dividends are voted in respect of the preference shares held by the spouse, children and/or any other family members who might be perceived to be under the control of the main earner, then HMRC might seek to pursue this under the existing settlements legislation. Their argument would be that the shareholders only have a right to income, but no say over how the company is run. Their right to income is merely to save the main income earner tax.

Guide to the Family Business Tax legislation on “income shifting”

SECTION TWO: THE FAMILY BUSINESS TAX

The Arctic Systems case identified that the settlements legislation was not sufficient, in HMRC’s words, “to undo the tax advantage gained by income shifting arrangements”. Therefore HMRC and HM Treasury issued a document on 6th December 2007 entitled ‘Income shifting: a consultation on draft legislation’ which requested comments by 28th February 2008.

Based on the consultation process involved in the introduction of the Managed Service Company (MSC) legislation (see the PCG website), it came as no surprise that this was issued at the busiest time of the year for the accountancy profession. Furthermore the consultation end date is less than 2 weeks before the Budget and less than 6 weeks before the proposals will become law with effect from the new tax year on 6th April 2008.

2.1 Government Proposals on “income shifting”

The Consultation process repeated the underlying principle within Angela Eagle’s Ministerial statement of 26th July 2007 that:

“The Government believes that it is right for everyone to pay income tax on their own income. The 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.

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”).

It should be noted that the Government continues to use the emotive term “income shifting” which seems to have underhand connotations, yet “income splitting”, which seems a less loaded description of the realities of the this type of tax planning, was only used once in the entire document.

In the introduction, HMRC also made reference to the continued use of the settlements legislation. The Revenue stated that 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. It also applies to arrangements under which income is paid to a minor child of the settlor. The settlements legislation continues to address many forms of income shifting satisfactorily, but it does not apply to certain income shifting arrangements currently in use.”

Hence, according to HMRC, the need for this new legislation.

The consultation document was issued jointly by the Treasury and HMRC, but we will use HMRC as a reference to both. We have opted to largely follow HMRC’s structure and terminology within the Consultation Paper to outline their thinking.

2.2 “Income shifting” within modern businesses

Business Structures

Use of a company structure

HMRC argues that where an individual establishes a business using a company structure, they may decide to introduce another individual as a second shareholder.

Guide to the Family Business Tax legislation on “income shifting”

For small businesses it is common for this individual to be a spouse, partner or other household member of the first individual. 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.

However, in some cases, HMRC is seeking to argue that the second individual is either not involved or only has minimal involvement in the business. The first individual has the sole or main responsibility for generating the business from which the income is then distributed. Despite this being the position, the income is distributed such that the first individual “forfeits” income which can then be distributed to the second individual and taxed at a lower rate. In these situations HMRC considers that income has been “shifted” from the first individual to the second.

Use of a partnership structure

HMRC believe a similar outcome can arise if two or more individuals decide to establish a business in partnership form (including a Limited Liability Partnership). By agreeing to a particular allocation of the partnership profit, the first individual can again forgo income so that it is taxed on the second individual at a lower rate.

HMRC provided some – by their own admission – very simplistic examples of what they consider to be “income shifting” and these are reproduced here in full:

“Nina and Charlie are a married couple. Nina wishes to start up a business as a freelance writer. She sets this up, involving Charlie in the structure of the business although he does not play any role in it. These examples assume that neither Nina nor Charlie has any other income and the calculations of tax are based on 2007 -2008 rates.

a) Using a company structure

Nina and Charlie each buy 50 shares in an off-the-shelf company. The business makes £60,000 of profit in its first year and, in order to reduce her tax liability, Nina decides to distribute all of the profit to the shareholders, Charlie and herself, as dividends. They each receive £30,000 in dividends although Charlie has not contributed directly to the generation of the business’s income.

There is no income tax charge on the dividends received because neither individual is a higher rate taxpayer. If Nina had paid all of the dividends to herself, she would have had a tax liability of £6,039. Alternatively, if Nina had traded as a sole trader, she would have had a personal tax liability of £15,414.

b) Using partnership structure

Rather than using a company structure, Nina sets up a partnership with Charlie. Again, the business generates £60,000 of profits and the profits are distributed 50:50.

Here Nina and Charlie have a combined tax liability of £10,344. If Nina had not formed a partnership with Charlie, and had traded as a sole-trader, she would have had a tax liability of £15,414 on the £60,000.

In both of the examples above, Nina has organised her business in such a way as to shift part of the income that she would otherwise have received to Charlie and therefore reduce her tax liability.”

“Simplistic” is somewhat of an understatement, as we suggest that very few businesses will be set up where the second individual has no involvement. There are no doubt many spouses and partners out there, who as the “second individual”, would argue that they probably live and breathe the business as much as the main fee earner does – and deserve every penny of the income distribution!

Guide to the Family Business Tax legislation on “income shifting”

HMRC does acknowledge that the contributions of individuals to the running of a small business will not be as simple as in the examples provided and therefore that it will 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.”*

Certainly the accountancy and tax profession has seized on this point. HMRC states that it will seek to take into account “the realities of running a business”. As there are very few Revenue Officers that will be able to call upon such experience, it will be interesting to see how far HMRC will be able to achieve this - we suspect it will become part of the running battle of each and every case that is subsequently challenged under this legislation.

2.3 Outline of the proposed legislation

The consultation document states that:

“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. Therefore the Government is proposing to introduce new legislation effective from 6th April 2008, focused specifically on “income shifting” arrangements that make use of companies or partnership to gain a tax advantage.”

The proposed legislation does not consider any situations where an arrangement has been made on a commercial or arms length basis. Within the legislation there are several conditions, all of which must be met for the legislation to apply. In summary:

- *Condition A - individual 1 is party to, or has power over 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 the amount that is shifted; and*
- *Condition D - the shifted income consists of distributions of a company or profits of a partnership.*

Additionally, the tax paid by individual 1 and individual 2 must be less than it would have been if they had not shifted income i.e. a tax advantage must have been obtained.

If all of these conditions are met the shifted income would be treated, for income tax purposes, as income of individual 1 and would not be taxed as income of individual 2.

It is intended that the treatment of Class 4 National Insurance Contributions would follow the tax treatment where a Class 4 liability arises following the shifting of income.

The legislation will apply to any income that forms part of individual 2's income on or after 6th April 2008, even where the shifted income is derived from an earlier period. For example, it would apply to a dividend paid to individual 2 on or after 6th April 2008 where the shifted income relates to company reserves from the year ending 5 April 2008 or earlier.

Interestingly, HMRC argues that the majority of business owners would be unaffected by the proposed legislation because they do not fulfil the conditions set out in the draft legislation. Nevertheless, in its *Consultation Stage Impact Assessment* (any proposed change in legislation has such a document signed off by the relevant Minister to justify why the proposed action is being put forward) HMRC argue that the minority of businesses at which this legislation is aimed is costing the Exchequer some £350m per annum.

Guide to the Family Business Tax legislation on “income shifting”

Therefore, in order to establish the correct treatment in these situations, it will be necessary to consider:

- *Is individual one in a position to shift income, with power to control or influence any arrangements? In other words, can individual one decide or secure how the profits from the business are distributed?*
- *Has that individual forgone income that formed part of the second individual’s income within an arrangement that would not be entered into at arm’s length?*
- *Does the shifted income consist of distributions from a company (for example, dividends) or a share of partnership profits?*
- *Has a tax advantage occurred as a result of shifting the income from the first individual to the second individual?*

The effect of the proposed legislation is that where a distribution made from a business represents shifted income, the individual who has forgone that income should include it on their self-assessment return at the end of the relevant year, for income tax purposes. Although the vast majority of such arrangements might involve individuals within one business entity, HMRC are also keen that the legislation should cover “income shifting” that might involve one or more corporate entities or partnerships.

In general terms, HMRC state that 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, they claim that the legislation would not apply where:

- Gaining a tax advantage is not the main or one of the main purposes of the arrangements;
- The individual whose income is shifted has no power to control or influence the amount of the income; or
- Notwithstanding that “income shifting” has taken place, there is no overall tax advantage.

The Detail of the legislation

The following information is reproduced from the Consultation Paper.

Condition A: relevant arrangements

Condition A applies where individual 1 is party to relevant arrangements, or has the power to control or influence the relevant arrangements. This is a factual test and depends on circumstances in each case.

Assessing whether individual 1 is a party to relevant arrangements is meant to be interpreted in the widest sense. Consequently, section 681E (6) makes clear that the term “arrangements” includes any agreement, understanding, scheme, transaction or series of transactions, whether or not legally enforceable.

Whether a transaction forms part or a series of transactions, or a scheme, or an arrangement, will be a question of fact. For example, it should be possible to make an assessment in any case where one transaction would not have taken place without another transaction, or would have taken place on different terms without that other transaction. However, the absence of such connection between transactions is not critical. There might still be a range of other factors that would lead to the conclusion that they formed part of a scheme or arrangements.

Guide to the Family Business Tax legislation on “income shifting”

In order to cover circumstances where arrangements or transactions take place in, or cover, more than one tax year the legislation does not provide any time limit. For example, individual 1 might be party to arrangements in year one but individual two does not receive the shifted income until the next, or a later, tax year.

Relevant arrangements are defined at section 681E as arrangements that are not genuine commercial arrangements and where it would be reasonable to conclude from all the circumstances of the case that the purpose, or one of the main purposes, is the avoidance of tax or the reduction of a charge to income tax.

Genuine commercial arrangements are defined in section 681E(2) in order to ensure that the legislation does not apply to arrangements that are made on terms that would have been made by individuals acting on arms length basis. In other words, the arrangements are the same as those that the individual would have been willing to undertake with an unconnected third party, also known as a “commercial basis”.

Where the business is one of making investments, or a combination of managing investments and carrying on a trade then, to be considered as a genuine commercial arrangement, the individual doing the work and the individual for whom the work is done must not be connected with each other and must be dealing with each other on an arm’s length basis.

The definition of “relevant arrangements” also requires that the main purpose, or one of the main purposes of any arrangement(s), is to gain a tax advantage. “Tax advantage” is not defined, but is intended to cover a wide variety of situations including the relief from tax, repayment of tax, the reduction in the amount of a charge to tax, and the reduction in the assessment of tax.

The purpose of the arrangements is determined by the purpose of the participants in entering into the arrangements and subsequent actions arising from those arrangements. For example if any participant has a main purpose of achieving a tax advantage, that will constitute a main purpose of the arrangements.

There is no single factor that determines whether the obtaining of a tax advantage is a main purpose of an arrangement. All the circumstances in which the arrangements were entered into need to be considered. The circumstances might include, but are not limited to:

- *The overall commercial objective. This should be considered not only from the perspective of all the participants in the arrangements, but also from any wider perspective and for these purposes a commercial objective does not include tax mitigation;*
- *Whether the objective is one which the parties involved might ordinarily be expected to have and which is genuinely being sought; or*
- *Whether the objective is being fulfilled in a straightforward way or whether the introduction of any additional complex or costly steps would have taken place were it not for the tax advantage that could be obtained.*

In practical terms, in considering whether the obtaining of a tax advantage was the main purpose, or one of the main purposes, of the arrangements it would be necessary to consider a number of factors. Typically these may include:

- *Whether the transaction giving rise to the advantage would have taken place at all;*
- *If so, whether the tax advantage would have been of the same amount; and*
- *Whether the transaction would have been made under the same terms and conditions.*

Guide to the Family Business Tax legislation on “income shifting”

Condition B: income forgone

Condition B is fulfilled where there are relevant arrangements in which:

- Individual 1 forgoes income; and
- The income forms part of the income of individual 2 for a tax year.

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.

“Forgoes income” is defined in section 681F. This provides that any income that individual 1 might reasonably have expected to have received if the relevant arrangements had not been in place is regarded as income forgone. In particular, it provides that regard should be given to the work done by individual 1 and all other relevant circumstances.

The definition relies on two tests. The first considers whether individual 1 is entitled to the income or would have been entitled to the income had it not been for the arrangements, but does not in fact receive it.

The second test considers that individual 1 might reasonably have expected to receive after taking into account the work done and all relevant circumstances.

Box B.1: Example A - a simple illustration of what is meant by “forgoes income”

Individual 1 provides services as a widget consultant through his sole trader business. The turnover for the year is £80,000 and profits after expenses are £60,000. This is a straight forward example and it is clear that individual 1's income is £60,000.

Now consider the same example as above, except this time individual 1 forms a partnership with individual 2 (but this could just as easily be a company). Individual 2 does not work and has no capital invested in the business. Individual 2's involvement in the business is merely to enable income to be paid to individual 2 to utilise their personal allowances and lower rate bands. Again the profits for the year are £60,000, but this time split equally between two equal partners in accordance with their agreed partnership-sharing ratio. Both individual 1 and individual 2 have received income for the year of £30,000. For the purposes of legislation, individual 1 will be treated as having forgone income of £30,000 to individual 2.

This example also illustrates that, in order to ascertain the amount of income forgone, the legislation looks through the form of the arrangements that may be in place in order to focus on their economic substance.

On the basis that individual 1 has undertaken all of the work in the partnership and generated all 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. Individual 2's income is described, as in section 681B4 (b), as shifted income, in this case quantified as £30,000.

In practice, the facts in each case will often be more complex than those in example A. Further guidance on how to quantify “shifted income” is set out in part 2 of this guidance.

Condition C: influencing the amounts of shifted income

Condition C is intended to ensure that the legislation only applies in circumstances where individual 1 has the power to control or influence the amount of the shifted income. This rule is necessary to ensure that the legislation does not apply where individual 1 has entered into arrangements but cannot subsequently affect the income received by individual 2. An example of this is shown below.

Guide to the Family Business Tax legislation on “income shifting”

Example B - The power to control or influence the amount of shifted income

Individual 1 owns 1000 shares in a major publicly listed company as an investor and gives 250 of these shares to individual 2, who in this example is her husband. Neither individual 1 nor individual 2 works for the company and, at some stage after the gift is made, the company declares a dividend, which is paid to individual 2. It is clear from this example that individual 1 cannot affect the timing or level of dividend declared by the company, as would be the case for any other minor investor. Consequently condition C is not met, so the new legislation would not apply in such circumstances.

In contrast, using the same scenario as above except that this time individual 1 owns 100% of the share capital in her private company and gives 250 shares to individual 2 (representing 25% of the share capital of the company). Individual 1 is able to affect both the level and timing of the dividend payable by the company and, for the purposes of the new legislation, condition C would be met.

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

Whether individual 1 has the power to control or influence the amount of shifted income is a question of fact. In the first scenario in example B, individual 1 is a minority shareholder in a listed company and the dividends are declared independently of any action taken by individual 1. In these circumstances it is clear that individual 1 does not have the power to control or influence any dividends paid to individual 2 after the shares have been gifted. In this context the timing of the gift is not an issue.

In contrast, in the second scenario in example B individual 1 retains a majority holding in her private company. Therefore she has the power to control and determine both the timing and the level of dividends payable in respect of the shares given to individual 2. Even if individual 1 gave all (or the majority) of the shares in the private company to individual 2, individual 1 might still be treated as having the power to control or influence any dividends paid to individual 2, where the timing or level of dividends are affected by any direct or indirect actions undertaken by individual 1.

These kinds of circumstances might also include individual 1 forgoing income by being paid a salary below the commercial value of any work done for the business, where individual 1 is able to direct the amount of income forgone through their formal role in the company, informal relationship with the shareholders, or where individual 1 is a shadow director.

Condition D: partnership profits or company distributions

Condition D is a straightforward factual test. It is fulfilled if the shifted income received by individual 2 is either:

- *A share of the income profits from a partnership (including a limited liability partnership); or*
- *Distributions (most commonly a dividend) as defined in section 989 Income Taxes Act 2007.*

Tax effects of the conditions

Where it has been established that “income shifting” has taken place, section 681C provides the rules for dealing with the income tax consequences. There are two steps to this.

Guide to the Family Business Tax legislation on “income shifting”

The first step considers individual 1 and treats the shifted income as part of their income for the relevant tax year. So in example A above (p12 of this guide), individual 1 would be treated as having income of £60,000, made up of £30,000 as his share of the partnership profits plus the shifted income of £30,000.

The second step is designed to avoid taxing the same income twice. The shifted income is treated as not forming part of individual 2's income for the relevant tax year. Again, in example A, the legislation would treat individual 2 as having income of £0, as all of the income received was shifted income, which is now being treated as individual 1's income.

There is no re-categorisation of the income shifted. The legislation treats the income received by individual 2 as if it were individual 1's income on a like or like basis. For example, the shifted income received by individual 2 may be dividends, in which case individual 1 would be treated as having received those dividends for tax purposes.

Condition A requires that the main purpose or one of the main purposes of the arrangement(s) is to gain a tax advantage. This is further reinforced by the exemption contained in section 681D, which is-applies section 681C if there is no overall income tax advantage even if all of the conditions A to D in section 681B have been met. The exemption applies when the total amount of income tax that would have been payable by individual 1 and individual 2 before applying the “income shifting” legislation is the same or less than the income tax payable by them with the application of the legislation.

Example C - exemption from the new legislation

Individuals 1 and 2 are the sole shareholders in their privately owned company. After reviewing their circumstances they agree that individual 1, for the purposes of the new legislation, has shifted income of £20,000 in the form of dividends to individual 2. Both individuals are higher rate taxpayers before taking into account the additional tax due in respect of this shifted income. In this case, the income tax due on the whole of the shifted income will be the same amount regardless of whether individual 1 or individual 2 pays the tax. Consequently, the exemption applies.

The exemption in section 681D refers to “the total amount of income tax which would be payable by individual 1 and individual 2 for the relevant tax year”. In calculating this, the fact that individual 2 may offset tax due on the shifted income by using losses available to them, or that they are not liable to UK income tax (for example, because they are resident outside the UK for tax purposes) is taken into account.

Guide to the Family Business Tax legislation on “income shifting”

SECTION THREE: PRACTICAL ISSUES

3.1 Record keeping

The consultation document suggests that the “income shifting” legislation does not mean that a business will have to maintain any additional records. 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. 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 - or so HMRC claim.

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-keeping requirements apply and the individuals should keep sufficient records to support any entry on their tax returns.

Commentary on Record-keeping

We disagree that this legislation will not change the nature of the record-keeping of a small family business. We believe it creates a need for businesses to document with much greater detail, the decision-making processes behind the course of action followed.

Let us consider someone working in a business, either on a full or part-time basis. One can record the number of hours worked and history has shown that HMRC take the blinkered and somewhat narrow view that the ‘input’ relates to physical work carried out. However, where family businesses are concerned, one cannot measure an individual’s contribution to the business by mere reference to those hours. How do you quantify the value of the advice and support given which may be at any time of the night or day? You certainly will not see this concept reflected in any of the many examples HMRC offer within the consultation document.

Abbey Tax Protection has previously dealt with a case where HMRC challenged the level of remuneration paid to the wife of a dentist who acted as the practice manager. HMRC accepted that the wife held a position of responsibility and acknowledged that the salary paid had been correctly taxed under PAYE but felt that the quantum of the salary paid to her was excessive and un-commercial. As such the business should not qualify for tax relief on the amount of the salary payments made to the wife that were deemed, by HMRC, to be excessive. What was even more bizarre in this case was that HMRC also contended that the receipt of the salary by the wife should be taxed in full as earnings from her employment.

We therefore had the situation where not only were HMRC trying to impose their view of what constituted a commercial salary for the duties performed but they were also content to see any amount that had been paid in excess of their figure to be taxed twice, firstly on the husband (because no tax relief was obtained on the payment) and secondly on the wife (under PAYE). To arrive at the level of an acceptable commercial salary HMRC merely considered the numbers of hours of attendance at the practice premises and took very little notice of work undertaken at home, partly because it was very difficult to quantify this work. The HMRC contention was rejected as inequitable and so the matter was ultimately referred to the General Commissioners. Fortunately, the Commissioners were able to grasp the concept that the wife’s input did not stop when she left the business premises, she was effectively on call 24 hours per day and being the wife of the proprietor this really did mean ‘24 hours per day’. As such, the Commissioners found that the salary paid to the wife was commensurate with her duties and responsibilities and the HMRC assessments were dismissed. A victory for common sense, but also entirely relevant to the “income shifting” debate.

Guide to the Family Business Tax legislation on “income shifting”

Although HMRC say that this proposed legislation will not have an increased record keeping requirement, how will anyone be able to demonstrate that an individual has been remunerated in accordance with their efforts or contribution to the business if they do not have appropriate records?

This is a very similar scenario to the recent case of Derek Conway MP, who paid both of his sons for services provided as research assistants. The MP contended that his sons had carried out work and had been remunerated in accordance with that work, but his failing was that he did not have any records to demonstrate this point. The Parliamentary Standards Committee concluded that there was no evidence to show that much work, if any, had been undertaken.

We would not want to comment on the rights or wrongs of this particular case but it does highlight, albeit in a very different context, the need to be able to demonstrate what work has been done. As such, it may be necessary to keep a record of *all* work undertaken even if the role in question would previously have been considered as just a sounding board to discuss the business or future strategies etc.

Quantification of the shifted income

It is the responsibility of individual 1 to determine the amount of income shifted and to make the appropriate adjustments for self-assessment purposes. The legislation deliberately does not prescribe a formula for quantifying the level of shifted income because the facts and circumstances will be different in each case.

HMRC expects individuals, together with their advisers, to use their own judgment on working out the level of shifted income. In doing so, they must adopt a reasonable basis for any conclusions reached.

Generally, there are three factors that might be considered in assessing whether the calculation of the amount of shifted income is reasonable. Firstly, it is clear that individuals may play a wide variety of roles within businesses, adapting where necessary to the needs of the business. In these circumstances, the first question that might be asked is whether the work done by individual 2 reasonably justifies the level of reward received, taking into account:

- *The type of work undertaken*
- *The amount of work done, and*
- *The extent of their responsibility for making key decisions in the running of the business.*

Those in the business are in the best position to access 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.

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 will be an important factor when considering businesses that have significant capital and assets, including goodwill.

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.

Guide to the Family Business Tax legislation on “income shifting”

These questions are not intended to be an exhaustive list of the factors to be considered in assessing the amount of the shifted income, but should be relevant in one permutation or another in most cases. The following example illustrates how some of these factors may be used in assessing the amount of shifted income. There will be other ways in which an individual may be able to quantify the level of shifted income and this will ultimately depend on the nature of the business and circumstances of the individuals concerned. Whatever basis is adopted, it should take account of all the facts in each case.

Example D - quantifying shifted income

The following situations are examples of what may be considered a reasonable basis for quantifying shifted income. They are for illustrative purposes only.

Scenario 1: individual 1 and individual 2 form a company, each owning fifty £1 ordinary shares. The business of the company is to provide the personal services of individual 1. Individual 2 spends around five hours a week on back office duties for the business. In the first year they each receive a salary of £5,000 and dividends of £30,000. The salary received by individual 2 is considered to be the market rate given the nature of the work done and time spent doing it. The company has no significant assets or liabilities other than the personal goodwill of individual 1.

If individual 2 has no capital in the business and bears no risk the whole of the £30,000 dividend paid to them would be treated as shifted income because individual 2 is already receiving a market rate for the work done, has no capital in the business and bears no risk.

Scenario 2: as above, except this time the market rate for the work done by individual 2 is considered to be £15,000. The shifted income would be £20,000 (i.e. £35,000 - £15,000 salary).

Scenario 3: as above, except this time individual 2 has £20,000 of capital invested in the business, which would have otherwise attracted a return of 10% per year if invested elsewhere (i.e. £2,000). The shifted income is £28,000 (i.e. £35,000 - £5,000 salary - £2,000 return).

Scenario 4: as above, except this time individual 2 has agreed to secure a business loan of £100,000 against the value of their home. The bank charges an interest rate of 10% on this secured loan, costing £10,000, but their normal unsecured rate is 22%. The shifted income is £18,000 (i.e. £35,000 - £5,000 salary - £12,000 (which is the difference between 22% and 10% on the loan of £100,000)).

Scenario 5: as above, except this time individual 2 has loaned the business £100,000. The business bank unsecured lending rate for small businesses is 20%. The shifted income is £10,000 (i.e. £35,000 - £5,000 - £20,000)

Scenario 6: as above, except this time individual 2 has capital in the business of £20,000 and has agreed to secure a business loan of £100,000 against the value of their home. Again the bank charges an interest rate of 10% on this secured loan, costing £10,000, but their normal unsecured rate is 22%. The shifted income is £16,000 (i.e. £35,000 - £5,000 salary - £2,000 to take account of the capital invested in the business - £12,000 to take account of the risks taken in the business).

Entries on self-assessment returns

Where income received reflects fairly and reasonably what individuals would be entitled to in a normal commercial arrangement, then no adjustment to that income should be made to self-assessment returns.

Guide to the Family Business Tax legislation on “income shifting”

Where “income shifting” has taken place then, in the case of a distribution from a company, individual 1 will need to increase the amount of income from distributions (typically dividends) on their return to take account of the shifted income, including the calculation of the tax credit. Individual 2 will need to reduce the figures for income from distributions by the corresponding amounts.

In the case of profits from a partnership, individual 1 will need to increase the figure for partnership profits on their return to take account of the shifted income and individual 2 will need to reduce the figure for partnership profits by the corresponding amount.

In both cases, each individual will need to provide an explanation of what they have done using both the white box on the return and identify the details of the other individual involved in the shifting of income. Further guidance on completing self-assessment returns will be published in due course.

In cases where the individuals do not receive a self-assessment return they should contact HMRC. Where individual 1 is concerned, this will be to notify HMRC that they have chargeable income on which they have not paid tax. In the case of individual 2, this is to enable a claim for any tax repayment that may be due as a consequence of tax paid on income that should be chargeable on individual 1. In both cases they will need to provide full details of the other individual involved in the “income shifting”.

How will individuals know if the other individual has shifted income?

The legislation would only apply to those individuals who have taken deliberate steps to shift income for the purposes of gaining a tax advantage. Accordingly, most individuals should know if they have been involved in “income shifting”.

However, there may be cases in which individual 1 has shifted income to individual 2 without the latter’s knowledge. In these cases, individual 1 has a responsibility to inform individual 2 what has happened and the amount of income to be re-allocated.

In the rare cases where individual 2 believes they may have been the recipient of shifted income from individual 1, without individual 1’s knowledge, they should verify this with individual 1 before making any adjustment to their return.

Disagreement between individual 1 and individual 2

Each individual is responsible for completing their own self-assessment return and will be responsible for providing details of any other parties involved in the “income shifting”. In cases where the individuals have used different amounts for the shifted income in their respective tax returns, HMRC may intervene through the normal enquiry process to ensure that a consistent approach is adopted for both individuals.

This may involve an adjustment to the level of shifted income used by either individual or both depending on the facts in each case.

HMRC enquiries

HMRC may enquire into whether the approach adopted in assessing the amount of shifted income was reasonable. If so, HMRC may ask to see the underlying records and other factors that have been used to assess the amount of income shifted. In addition, HMRC may ask for sight of any business records or other documents that might be relevant in assessing the amount of income shifted. This might include any of the following:

- *Documentation showing how an individual has arrived at the amount of the income shifted;*
- *Documentation that demonstrates 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.;*

Guide to the Family Business Tax legislation on “income shifting”

- *Documentation that demonstrates 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*
- *Documentation that demonstrates 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.*

Boundary with existing legislation

Settlements legislation

There will be no change in the way in which HMRC will view or apply the existing settlements legislation. The “income shifting” legislation would only apply if a tax advantage were still obtained from “income shifting” after taking into account the rules contained in the existing settlements legislation.

Managed Service Company legislation

Following Finance Act 2007, any company within the statutory definition of a Managed Service Company must from 6th April 2007 treat all payments or benefits made to a worker (the person or persons whose services have generated the company’s income), or an associate, as earnings from employment of the worker. Where the legislation applies, and all of the income is treated as employment income of the worker, there is no need to consider other “income shifting” rules.

“Income shifting” by gift

Generally, income arising from the gift of assets will be outside the scope of the new legislation. However, the legislation may apply to “income shifting” arising from gifts that form part of an arrangement resulting in income being received by individual 2 in the form of a distribution from a company or a share of partnership profits.

3.2 How the legislation might be applied in practice

It is understandable when viewed from the Government’s perspective, why it might want to consider arrangements where extraordinary steps have been taken merely to reduce the overall tax burden. However, the danger with any new legislation is how it will be applied in practice by HMRC.

The self assessment regime requires the individual to declare any income that may have been shifted to someone else. This is clearly a subjective test of both fact and degree.

The draft HMRC examples listed in Appendix B demonstrate that it may be relatively easy to make a decision at the extremes but unfortunately nothing is black and white. Also the examples provided refer to the ‘input’ into the business of the second individual but do not show how to measure this ‘input’.

To determine whether the “income shifting” legislation may apply to you consideration must be given to the four tests reproduced below. Yet remember, unlike the Settlements Legislation, “income shifting” will apply if income is shifted from one individual to another; there is no requirement for the individual to have retained an interest in the income. In effect, this widens the scope of HMRC powers.

- **Condition A - individual 1 is party to, or has power over the relevant arrangements;**
- **Condition B - individual 1 forgoes income and the forgone income is individual 2’s for the relevant tax year.**

Guide to the Family Business Tax legislation on “income shifting”

- Condition C - individual 1 has the power to control the amount that is shifted; and
- Condition D - the shifted income consists of distributions of a company or profits of a partnership.

Additionally, the tax paid by individual 1 and individual 2 must be less than it would have been if they had not shifted income i.e. a tax advantage must have been obtained.

In making any decision, perhaps the best place to start is the final condition: is there a tax advantage? It is expected that this is where HMRC will focus their efforts to determine when to open an enquiry although, of course, the commercial motives for any arrangements must not be dismissed.

If it can be seen that a tax saving has arisen, consideration then needs to be given to the four remaining criteria. Although normal logic would suggest you work from A to D, it may be easier to look at the conditions in a different order to establish whether any arrangements are outside the scope of the legislation.

Condition D requires that the income received by individual 2 must be a company distribution or profits of a partnership. Consequently, if you pay someone a salary that is taxed under PAYE this will not fall within the “income shifting” legislation; although HMRC will want to ensure that the level of salary is commensurate with the work undertaken (see narrative above). Conversely the legislation could apply if individual 2 receives dividends or a share of the partnership profits. This is a matter of fact and so can be determined with a degree of certainty.

Assuming condition D is satisfied consideration should be turned to **Conditions A and C**. If a family company or Partnership is being used, it will be fairly easy for HMRC to show that individual 1 will be party to or have the power over the arrangements and as such will be able to influence the amounts involved. This may not be the case where individual 1 is a minority shareholder or Partner and cannot exert any influence over the other shareholders or partners. This is a question of fact and degree but it should be possible to reach a decision with a degree of certainty.

This then leaves **Condition B** which requires the income being shifted to be that of individual 1. This is where a subjective test will have to be applied. It can be seen from the HMRC example 1 reproduced above that where two individuals both work in a business on a full time basis, with equal effort, the “income shifting” legislation will not apply just because individual 1 is the only fee earner. Consideration needs to be given to the rewards being received by each individual in relation to the work they undertake and any financial risk they carry such as investing capital in the business.

It is the responsibility of the individuals involved to determine whether and to what extent the legislation should apply and this can only be done on an individual basis based on the facts and information available. Any decision made will be open to challenge by HMRC who, if past history is repeated, may not consider the wider benefit to the business, just the number of hours worked. Whatever decision you make, you should record why you made the decision and retain any records used in the decision-making process to demonstrate the extent of each individual's input.

If having considered the above, you determine that you are caught by the “income shifting” legislation, you will need to determine the quantum of the income that has been shifted to another individual. This amount must then be declared on your own Tax Return with an appropriate note being made within the ‘white space’. This income will then be included with your other chargeable income and taxed at whatever rate you are liable at. The amount of additional tax will depend on the level of ‘shifted’ income that you declare and your marginal rate of tax.

Guide to the Family Business Tax legislation on “income shifting”

3.3 Can I re-arrange my affairs to take myself outside of the legislation? Should I?

This is a very difficult question to answer. If one looks at the Government’s reasoning for the legislation, then you might think that the obvious answer is to operate as a sole trader! However, if you do so, then as a freelancer your contracting opportunities are likely to end with immediate effect.

You could operate through a limited company as the sole shareholder, but this will only increase HMRC’s arguments to pursue IR35.

If you follow HMRC’s logic, then pay both individuals a high salary (but, of course, commensurate with their duties) with minimal dividends, which is unlikely to be a palatable alternative to any freelancer who sees the ability to minimise tax as a just reward for taking entrepreneurial risk.

Until we fully understand what impact this legislation may have, we can only advise that you document the businesses plans and the course of action the business takes so that you can justify the decisions you have taken in connection with your company’s remuneration strategy.

As ever, take professional advice.

3.4 “income shifting” FAQs

For the purposes of these questions individual 1 will be taken to be a husband and individual 2 to be his wife. This is purely for simplicity: the legislation will apply equally to married couples, civil partners and unconnected persons in any and all combinations.

1. Isn’t it possible to work outside the new rules, like you can with IR35?

The proposed legislation includes four conditions that have to apply before you fall within the “income shifting” arrangements.

- Individual 1 is party to, or has power over the relevant arrangements;
- Individual 1 forgoes income and the forgone income is individual 2’s for the relevant tax year
- Individual 1 has the power to control the amount that is shifted;
- The shifted income consists of distributions of a company (usually dividends) or profits from a partnership

There is also one overarching requirement that as a result of the “income shifting” there must be a tax saving.

If you do not meet these conditions then this legislation will not apply to you. As with the IR35 legislation some conditions use subjective tests and so are open to interpretation.

2. I own a company jointly with my girlfriend, but we are not married: so we’re not caught, right?

No, the “income shifting” legislation can apply where income is shifted from one individual to another. These individuals do not have to be connected.

3. My wife only owns 40% of the shares in our company: is it still possible for us to be caught by the rules?

Yes, if your wife received 40% of the dividends voted by the company and this is not deemed to be a fair allocation of the company profits, the legislation can apply where there is an overall tax saving.

4. I own a company jointly with my civil partner: do the rules apply?

Yes, the “income shifting” rules can still apply.

Guide to the Family Business Tax legislation on “income shifting”

5. Should I re-structure my company, so that I own it exclusively?

If you own all of the shares of your company then the “income shifting” legislation cannot apply because you will be entitled to receive all of the dividends and pay tax on these accordingly. Effectively, you will be producing the same result as that intended by the legislation.

6. Should I pay out the funds in the company before 6th April?

This is something that you could consider because this legislation will only apply to distributions made after 5th April 2008. However, you will need to consider the impact on the company on paying out its reserves and also the taxation consequences on receiving a higher level of dividend in the 2008 fiscal year; this may result in an increased higher rate tax liability. You need to discuss this with your accountant or tax adviser in light of your overall financial position.

7. Does it matter whether our business provides goods or services?

No.

8. Will an offshore company be exempt from the rules?

The effect of the proposed legislation is that where a distribution made from a business represents shifted income, the individual who has forgone that income should include it on their self-assessment return at the end of the relevant year, for income tax purposes. Therefore it is where the individual pays tax, not where the company is located that matters. If you are a UK taxpayer and as a result of “income shifting” you have paid less tax, then you can still be caught by the legislation.

9. My wife and I were not motivated by tax savings when we formed the company: surely this takes us out of the scope of the legislation?

No. Although tax saving was not your motivation, if there is an overall tax saving and the arrangements are such that your wife receives a disproportionate share of the company profits in relation to the work and risks undertaken by her, the legislation can apply.

10. My wife does the book-keeping for our business, and currently receives a salary that we are pretty sure is a fair market rate: she is a trained book-keeper and has knowledge of the market. The consultation document seems to say a shareholder is entitled to receive a market value for work done, irrespective of how it is paid: should I switch to paying her for the book-keeping via a dividend, rather than PAYE?

There are a number of points to be considered here, before you even worry about “income shifting”. Firstly, any salary paid to your wife is a deductible expense that will reduce your corporation tax liability; secondly, your wife will be forgoing the personal allowances upon which no tax or NIC contributions are payable (by either her or the company); thirdly, if she does not receive a salary, then she will be making no NIC payments which will count towards her pension.

In order to pay dividends, the company must have reserves. If you have a period without a contract, will there be sufficient reserves to pay a dividend? Or put another way, will your wife have undertaken all the work for no reward?

Does your wife currently hold shares? If not, then you will need to reallocate the shareholding and if so, is the reallocation in line with your wife’s input into the business? This is now the point to consider “income shifting” and you should refer to the answers to FAQs 1 and 3.

Guide to the Family Business Tax legislation on “income shifting”

11. What records should I keep? Are timesheets necessary?

You should retain any records used in reaching your decisions as to whether the legislation applies. If your conclusion is that the legislation does apply, you should keep any records used to determine how much income you deem to have been shifted. This should entail records of work undertaken by your spouse.

12. Where can I get information to calculate market rates for my wife’s various contributions to the company?

The market rate will depend on exactly the nature of the work undertaken by your wife. Firstly, you need to record and detail all duties and responsibilities of your wife and then consider these duties against local market forces. This could be by reference to job advertisements in the local press or Agencies, but remember you must be paying at least the National Minimum Wage.

13. Will the insurances with my PCG membership cover the costs of an investigation under the new rules? How do I claim?

HMRC will undertake an Income Tax Self Assessment Enquiry into “income shifting” by issuing a Notice s9A into the individual’s self-assessment return. It is likely that such an enquiry will take the form of an Income Tax Aspect Enquiry, which is covered under PCG’s policy with a £150 excess and a £1,500 Upper Limit of Indemnity. If “income shifting” forms part of an Income Tax Full Enquiry, then there is no excess and the standard policy limit of £75,000 applies. Claims should be made in the normal way by downloading the claims form from the PCG website, completing it and sending the form together with the relevant correspondence to PCG, who will then forward the information to Abbey Tax Protection.

14. Is it possible to show my wife to be generating revenue for the company by, for example, selling items on Ebay? Would it matter if the buyer is always me?

If your wife generates income for the business this will not prevent the “income shifting” legislation from being applied although it may alter the amount of income deemed to have been shifted. However, if items are sold in the manner suggested, any income received will be added to the company turnover and taxed accordingly. If these items are sold on a no profit/no loss basis, HMRC will challenge the arrangements as being non-commercial and so they will be ignored for these purposes.

15. The consultation document seems to say that higher dividends might be acceptable if there is risk involved, for instance a loan secured on the family home? Can we save tax by taking out a loan secured on our house?

The proposed legislation will target any arrangements where it is considered that income has been shifted from one individual to another. Even where the legislation does apply consideration needs to be given to the amount of the income shifted and in reaching this conclusion you need to determine the amount of income that you would expect individual two to have received based on their work or financial risk.

Where the second individual risks capital in the business this can be taken into account in determining their share of the profits that will not be affected by the proposed legislation. However, the amount to consider is not the amount of capital introduced but the difference between the interest that the company would have been charged if the loan had been obtained from a bank, and the interest charged to the individual.

16. Can my company be caught simultaneously by this and IR35?

It is unlikely that this will happen because if you are caught by IR35 the income generated by the company will be subjected to the deemed calculation and so it is unlikely that any dividends will be paid.

Guide to the Family Business Tax legislation on “income shifting”

However, the legislation will apply to any dividends paid after 5th April 2008 and these could relate to retained profits that arose prior to this date. Consequently, if you entered a new contract on 6th April 2008, that is caught by IR35, this would be subjected to the deemed calculation but you could still vote dividends from retained profits held at 5th April 2008. If these dividends met the ‘conditions’ the proposed legislation could apply even though IR35 was being applied during the same period.

17. I own a company jointly with someone to whom I am not in any way related: we both contribute fully to running the business but we do quite different things within it that may not be of a totally equal “commercial” value; but we split the profits 50-50. Could we be caught by the new legislation?

Again, please see the answer to FAQ 2 (p22 of this guide), whether the individuals are connected or not, is not relevant for the purposes of “income shifting”. The legislation could apply in this situation if it were determined that the 50% share paid to the second individual was not representative of their input. Each case will need to be judged on its merits and only the amount that exceeds the normal commercial value will have to be declared as being shifted.

HMRC’s example 11 from the consultation paper is very similar to this FAQ and involves a graphic design partnership where one partner is producing the fee earning work; the other manages and promotes the business. Their contribution to the business, though different is deemed to be equal and it is correct that profits are split equally. In subsequent years, individual 2 works part-time and accepts a lesser split of the profits and so HMRC accept that there is no “income shifting”.

There are further examples where the circumstances of individual 2 change and on some occasions “income shifting” does apply, but on other occasions it may not. What we have learned from the Consultation is that the examples at the extreme are fairly clear cut, but there is plenty of grey in the middle and indeed many shades of grey.

In short, the answer, as for many things in the tax arena, is: “it depends”!

18. If my company sub-contracts out some work to an external supplier, are my wife and I entitled to split the profits from that contract (after the supplier has been paid) 50-50 without being caught by the new rules?

Not necessarily. The overall income split will have to reflect the normal commercial arrangements that would exist on an arm’s length basis. If your wife sourced the work, engaged the sub-contractor and then managed the project on behalf of your company, this would clearly increase the input of your wife and as such the commercial level of payments to her. Conversely, if your wife had little or no involvement with the sub-contractor the new legislation is likely apply.

19. When are HMRC likely to start opening enquiries under these rules?

The proposed legislation is due to take effect from 6th April 2008. You will have to declare the income from this period on your 2009 self-assessment return; which is due to be issued to you in April 2009. The 2009 self-assessment return must be submitted by 31st January 2010 and HMRC can start an enquiry at any time prior to 31st January 2011.

An enquiry cannot be started until the self-assessment return has been submitted and on the assumption that most self-assessments are submitted to HMRC within six months of issue, it is unlikely that any enquiries will commence until late 2009.

Guide to the Family Business Tax legislation on “income shifting”

20. Have any of the concepts used in the legislation been tested in case law, eg “arm’s length” or “commercial” arrangements, “forgoes income”, “reasonable to draw the conclusion”? What might the implications be for our tax planning?

The draft legislation to be incorporated within Part 13 ITA2007 does define some of the terms used in connection with “income shifting”. “Relevant arrangements” are defined at s681E as “arrangements that are not genuine commercial arrangements and it could be reasonable to draw the conclusion that ... one of the main purposes is the avoidance or reduction of a charge to income tax.”

The term “forgoes income” is defined at s681F is where individual 1 is entitled to receive the income but does not receive it, or having regard to any work done by individual 1 and all the other relevant circumstances, individual 1 might reasonably be expected to receive income but doesn’t do so”.

Phrases such as “commercial arrangements” and “arm’s length” retain their everyday meaning, but are subjective which, of course, leads to uncertainty.

Guide to the Family Business Tax legislation on “income shifting”

APPENDIX A: DRAFT LEGISLATION, DECEMBER 2007

1 Income-shifting

(1) In Part 13 of ITA 2007 (tax avoidance), insert at the beginning—

“CHAPTER A1
INCOME-SHIFTING

681A Overview of Chapter

This Chapter makes provision for counteracting income tax advantages obtained by income-shifting.

681B Income-shifting

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

(2) Income is shifted from individual 1 to individual 2 if conditions A to D are met.

(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.

(4) Condition B is that, pursuant to the relevant arrangements—

- (a) Individual 1 forgoes income (“the forgone income”), and
- (b) any of the forgone income, or any income (directly or indirectly) deriving from or otherwise representing any of the forgone income, would be income of individual 2 (“the shifted income”) for a tax year (“the relevant tax year”).

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

(6) Condition D is that the shifted income would consist of—

- (a) distributions of a company, or
- (b) profits of a partnership.

(7) For the meaning of “relevant arrangements” and “forgoes income”, see sections 681E and 681F respectively.

Guide to the Family Business Tax legislation on “income shifting”

681C Tax effects of income-shifting

- (1) The shifted income is to be treated for the purposes of income tax—
 - (a) as forming part of the income of individual 1 for the relevant tax year, and
 - (b) as not forming part of the income of individual 2 for that tax year.

- (2) This section is subject to section 681D (exemption where no tax advantage).

681D Exemption: no tax advantage

Section 681C does not apply where—

- (a) the total amount of income tax which would be payable by individual 1 and individual 2 for the relevant tax year if subsection (1) of that section did apply, is less than or equal to
- (b) the total amount of income tax which would be payable by them for that tax year if that subsection did not apply.

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
 - (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.

- (2) Arrangements are genuine commercial arrangements only if conditions A, B and C are met.

- (3) Condition A is that the arrangements are effected—
 - (a) in the course of a trade or business and for its purposes, or
 - (b) with a view to setting up and commencing a trade or business and for its purposes.

- (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.

- (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.

Guide to the Family Business Tax legislation on “income shifting”

(6) In this Chapter “arrangements” includes any agreement, understanding, scheme, transaction or series of transactions (whether or not legally enforceable).

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.”

(2) The amendment made by subsection (1) has effect in relation to income which (apart from that amendment) would have formed part of the income of Individual 2 for the tax year 2008-09 or a later tax year.

Guide to the Family Business Tax legislation on “income shifting”

APPENDIX B: DRAFT EXAMPLES FROM THE CONSULTATION PAPER

The following examples are included to further illustrate the scope of the legislation. These do not constitute an exhaustive list and the application of the legislation would depend upon the facts in each case.

Examples involving partnerships

Example 1

This example illustrates a scenario that would be outside the “income shifting” legislation because there is no evidence of any arrangements with the object of securing a tax advantage.

Individual 1 and individual 2 form a partnership to provide graphic design services. Each introduces £100 of capital into the business. Individual 1 provides the graphic design services to customers and individual 2 manages and promotes the business of the partnership. They both work full-time and develop the business together. Trading profits for the year are £80,000, which are split between individual 1 and individual 2 equally (i.e. each partner receives £40,000)

The new legislation would not apply in this case because income has not been shifted. The share of the profits received by individual 1 and individual 2 reflects the balance of labour and capital put into the business. The arrangement between individual 1 and individual 2 is a commercial one, which means that the test in condition A of section 681B has not been met.

Example 2

This example illustrates a scenario that would be covered by the “income shifting” legislation. Despite each partner introducing equal capital to the business, a tax advantage is obtained through a division of income between the partners that does not reflect what they would be entitled to in a normal commercial arrangement. This is because of the differing levels of labour they contribute.

Individual 1 and individual 2 form a partnership to provide graphic design services. Each spouse introduces £100 of capital into the business. Individual 1, who is a graphic designer, carries on the trade of the partnership while individual 2 does no work for the partnership. Trading profits for the year are £80,000, which are split between individual 1 and individual 2 equally (i.e. each partner receives £40,000)

The new legislation would apply in this case because the income has been shifted. The share of the profits received by individual 1 and individual 2 does not reflect the balance of labour and capital put into the business. The arrangement between individual 1 and individual 2 appears to be non-commercial and has enabled individual 1 to forgo income that they otherwise should have been received.

Example 3

This example illustrates a scenario that would be covered by the “income shifting” legislation. Despite each partner providing equal labour for the business, a tax advantage is obtained through a division of income between the partners that does not reflect what they would be entitled to in a normal commercial arrangement. This is because of the differing levels of capital that they have introduced to the business.

Guide to the Family Business Tax legislation on “income shifting”

Individual 1 and individual 2 form a partnership and start trading as a local grocery. Individual 1 introduces £200,000 of capital into the business, which is used to acquire the shop premises and stock. Individual 1 and individual 2 both work full time in the business and develop it together. Neither individual 1 nor individual 2 bring any special skills into the business. Trading profits for the year are £80,000, which are split between individual 1 and individual 2 equally (i.e. each partner receives £40,000).

The new legislation would apply in this case because the income has been shifted. The profit share received by individual 1 and individual 2 do not reflect the balance of the labour and capital put into the business. The arrangement whereby individual 2 is entitled to an equal share of the profits and a return on capital of the business even though individual 2 has not contributed any capital appears to be non-commercial. Individual 1 has forgone income that individual 1 may have otherwise received in relation to the capital contribution (i.e. a return on individual 1's capital).

Example 4

This example illustrates a scenario that would be outside the “income shifting” legislation. Although the division of profits is unequal and does not appear to reflect the normal commercial position that would be expected (where the same capital and labour is contributed by each partner), a tax advantage is not obtained.

Individual 1 and individual 2 form a partnership and start trading as a local grocery. Individual 1 and individual 2 each introduce £100,000 of capital into the business, which is used to acquire the shop premises and stock. Individual 1 and individual 2 both work full time in the business and develop it together. Neither individual 1 nor individual 2 bring any specialist skills into the business. Trading profits for the year are £40,000, which, under the partnership agreement, are allocated 1/8 (£5,000) to individual 1 and 7/8 (£35,000) to individual 2. The partnership agreement entitles individual 1 and individual 2 to an equal share of the capital value of the business and its assets, including any cash in the partnership.

The shares of profit received by individual 1 and individual 2 do not reflect the balance of labour and capital put into the business. The arrangement appears to be non-commercial and this has enabled individual 1 to forgo income that they would otherwise have received as an equal partner in the business. Therefore it would appear that the legislation would apply. However, the combined tax payable by individual 1 and individual 2 is the same as would have been paid had the income not been shifted and therefore the exemption at Section 681D applies.

Example 5

This example illustrates a scenario that would be outside the “income shifting” legislation. Despite each partner contributing different levels of capital and labour, there is no evidence of arrangements set up with the object of securing a tax advantage. The income received by each constitutes a fair commercial arrangement.

Individual 1 and individual 2 form a partnership to provide graphic design services. Individual 2 introduces £200,000 of capital into the business. Individual 1, who is a graphic designer, carries on the trade of the partnership while individual 2 does no work for the partnership. Trading profits for the year are £70,000 which are split between individual 1 and individual 2 equally (i.e. each partner receives received £35,000). £35,000 is considered an arm's length return on individual 2's investment of £200,000,

Guide to the Family Business Tax legislation on “income shifting”

The new legislation would not apply in this case because income has not been shifted. The arrangement between individual 1 and individual 2 appears to be commercial as each partner receives an equal share of profits having contributed equally to the partnership, albeit in different ways.

Example 6

This example illustrates a scenario that would be outside the “income shifting” legislation. No tax advantage is obtained despite payments being made to parties connected to a partnership at a non-commercial rate.

Individual 1 and individual 2 are in partnership running a decorating business. The business wins a contract with a tight timescale and some of individual 1’s relatives assist them with the contract to complete it in time. The relatives are paid a nominal amount for the help, thus reducing the eventual partnership profits.

Individual 1 has used their control of the business to shift income to people connected to them at a non-commercial rate. However, this would not be within the scope of the legislation as no tax advantage is sought or obtained despite the amounts paid being below a commercial rate.

Examples involving companies:

Example 7

This example illustrates a scenario that would be covered by the “income shifting” legislation. A tax advantage is obtained though a division of income between shareholders that does not reflect the normal commercial arrangement that would be expected given the different levels of capital and labour contributed by each.

Individual 1 and individual 2 set up a company to exploit the personal services of individual 1, who is a graphic designer. The ordinary share capital is £1, consisting of one hundred ordinary 1p shares. Individual 1 and individual 2 each own 50% of the share capital. Individual 1 carries on the trade of the company, working full time, while individual 2 does not do any work for the company. Trading profits for the year are £80,000, after taking into account a salary of £10,000 for individual 1. Dividends of £35,000 each are declared and subsequently paid to individual 1 and individual 2 for that year.

The new legislation would apply in this case because income has been shifted. The share of profits received by individual 1 and individual 2 does not reflect the balance of labour and capital put into the business. The arrangement between individual 1 and individual 2 appears to be non-commercial and has enabled individual 1 to forgo income that they would have reasonably been expected to receive given the specialist skills employed in the business. As a shareholder of the company, individual 2 is entitled to a dividend equal to the one received by individual 1, but unless there are other factors involved, there does not appear to be a commercial justification for these arrangements.

Example 8

This example illustrates a scenario that would be outside the “income shifting” legislation. No tax advantage is obtained and no income shifted despite each shareholder contributing different levels of labour and the work of one influencing the value of distribution to another, because the overall income received by each appears to constitute a fair commercial arrangement.

Guide to the Family Business Tax legislation on “income shifting”

Individual 1 and individual 2 set up a company and start trading as a plumbers' merchant. They each introduce capital of £50,000 into the business, which is used to acquire the shop premises and stock. Individual 1 works full time for the business and individual 2 works one day a week. The success of the business relies heavily on the skill and personal contacts of individual 1, who is a qualified plumber. 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). Dividends of £20,000 are declared and subsequently evenly between individual 1 and individual 2.

The new Legislation would not apply in this case because income has not been shifted. The arrangement between individual 1 and individual 2 is on a commercial basis. Individual 1 receives a market salary for their work and shares dividends with Individual 2 as equal shareholders in a company where they have introduced an equal amount of capital.

The legislation should not capture instances where an individual works for a company on an arm's length basis but, through their work, they significantly influence the value of the distributions from the company to another individual.

Example 9

This example illustrates a scenario that would be outside the “income shifting” legislation. No tax advantage is obtained despite payments being made to parties connected to controlling directors in a company at a non-commercial rate.

Individual 1 is the 100% shareholder director of a stone masonry company. The children of individual 1 (individual 2 and individual 3) work for the company and receive a salary at below a commercial rate for the work they do. Those salaries reduce the net profits available for distribution. Consequently, it might be argued that individual 1 has used their control of the business to shift income to persons connected with them and that this is not a genuine commercial arrangement.

However, this example is clearly not covered by the legislation. Individual 1 does not forgo income to individual 2 and individual 3. Additionally, it would not be reasonable to argue that the arrangement is in place to gain a tax advantage. Furthermore, the payments to individual 2 and individual 3 are not distributions of company profits. That the arrangement is non-commercial does not bring the example into the scope of the legislation in itself.

Examples involving changes in arrangements over different periods:

Example 10

This example illustrates a scenario that would be covered by the “income shifting” legislation. A tax advantage is obtained when the division of income between partners fails to keep up with the changing level of labour contributed by each that would be reflected in a normal commercial remuneration arrangement.

In year one, individual 1 and individual 2 form a partnership to provide graphic design services. Each individual introduces £100 of capital into the business. Individual 1, who is a graphic designer, carries on the trade of the partnership while individual 2 manages and promotes the business of the partnership. They both work full time and develop the business together. Trading profits for the first three years are £80,000 per year, which are shared between individual 1 and individual 2 equally. In year four, individual 2 decides to stop working for the business, but continues to retain a partnership share in the business.

Guide to the Family Business Tax legislation on “income shifting”

The trading profit for year four is £80,000, which is wholly attributable to the work done by individual 1 and, as in previous years, profits are shared equally between individual 1 and individual 2.

“income shifting” has not occurred in years one to three because the arrangements were fully commercial. In year four, while there is no change to the ownership of the partnership or individual 2’s legal entitlement to the profit share, there is a change in the wider arrangements because individual 2 has stopped working for the partnership. “income shifting” has occurred in year four because the profits attributed to individual 2 are not commensurate with their contribution to the partnership.

Example 11

This example illustrates a scenario that would be outside the “income shifting” legislation. No tax advantage is obtained and no income shifted despite a change in the level of labour contributed by the partners. The division of overall income between partners keeps up with the changing level of labour contributed by each and thus reflects what would be expected in a normal commercial remuneration arrangement.

In year one individual 1 and individual 2 form a partnership to provide graphic design services. Each individual introduces £25,000 of capital into the business. Individual 1, who is a graphic designer, carries on the trade of the partnership while individual 2 manages and promotes the business of the partnership. They both work full time and develop the business together. Trading profits for the first three years are £80,000 per year, which are shared equally between individual 1 and individual 2. In year four, individual 2 decides to work for the business on a part time basis, but continues to retain a partnership share in the business. Individual 2 agrees to receive a lower share of the profits to reflect their reduced contribution to the business. The trading profits for year four are £80,000 and it is decided that the profits should be shared between individual 1 and individual 2 on a 70:30 basis to reflect their respective contributions to the business for that year.

The new legislation would not apply in this case because income has not been shifted. The arrangement was commercial in years one to three and continues to be commercial in year four.

Example 12

This example illustrates a scenario that may be covered by the “income shifting” legislation. A tax advantage is obtained when the division of income between partners fails to keep up with the changing levels of capital contributed by each that would be reflected in a normal commercial remuneration arrangement.

In year one individual 1 and individual 2 form a partnership to provide graphic design services. Each individual introduces £50,000 of capital into the business. Individual 1, who is a graphic designer, carries on the trade of the partnership while individual 2 manages and promotes the business of the partnership. They both work full time and develop the business together. Trading profits for the first three years are £80,000 per year, which are split between individual 1 and individual 2 equally. In year four, individual 2 decides that they do not want to risk their capital in the business and they withdraw it from the business. Both individual 1 and individual 2 continue to work in the business as before, but now only individual 1 has capital in the partnership. Despite this, the profit is shared equally between individual 1 and individual 2. The trading profits for year four are £80,000, with each partner receiving £40,000.

Guide to the Family Business Tax legislation on “income shifting”

Income has not been shifted in years one to three, as the arrangements were commercial. Whether the removal of capital from the business by individual 2 in year four is sufficient to make the arrangements non-commercial will depend on the facts. Initially, the arrangement may appear to be non-commercial because individual 1 has contributed labour and capital while individual 2 has only contributed their labour and the legislation may apply. However, where there are other factors that indicate that the arrangements remain commercial, the legislation may not apply.

Example 13

This example illustrates a scenario that would be outside the “income shifting” legislation. No tax advantage is obtained and no income shifted despite a change in the level of capital contributed by the partners. The division of overall income between partners keeps up with the changing level of capital contributed by each and thus reflects that would be expected in a normal commercial remuneration arrangement.

In year one individual 1 and individual 2 form a partnership to provide graphic design services. Each individual introduces £50,000 of capital into the business. Individual 1, who is a graphic designer, carries on the trade of the partnership while individual 2 manages and promotes the business of the partnership. They both work full time and develop the business together. Trading profits for the first three years are £80,000 per year, which are shared equally between individual 1 and individual 2. In year four, individual 2 decides they do not want to risk their capital in the business and it is withdrawn. The business makes trading profits of £80,000. This time the profits are split between individual 1 and individual 2 to reflect their contributions to the partnership with individual 1 receiving £45,000 and individual 2 receiving £35,000.

The new legislation would not apply in this case because income has not been shifted. The arrangement was commercial in years one to three and continues to be commercial in year four.

Example 14

This example illustrates a scenario where, despite the level of overall income received by each partner failing to reflect changes in labour contributed by each, the question of whether the “income shifting” legislation would apply depends on the specific circumstances of each case.

In year one individual 1 and individual 2 form a partnership to provide graphic design services. Each individual introduces £50,000 of capital into the business. Individual 1, who is a graphic designer, carries on the trade of the partnership while individual 2 manages and promotes the business of the partnership. They both work full time and develop the business together. Trading profits for the first three years are £80,000 per year, which are shared equally. In year four, individual 2 does not work for a year and, during that time, individual 1 continues to work in the business providing the graphic design services to customers as before, but also now manages and promotes the business of the partnership on their own. However, profits are still shared equally between individual 1 and 2. The trading profits for year four are £80,000, with each partner receiving £40,000. In year five, individual 2 returns to work for the business, the business again makes trading profits of £80,000, which continue to be shared equally.

Guide to the Family Business Tax legislation on “income shifting”

Income has not been shifted in years one to three, as the arrangements were commercial. Whether individual 2 taking the year off work in year four is sufficient to make the arrangements non-commercial will depend on the facts. Initially the arrangements may appear to be non-commercial because individual 1 has contributed labour and capital while individual 2 has only contributed their capital, and the legislation may apply. However there will be instances where this is not the case and the arrangements would continue to be commercial, so the legislation would not apply. For example, the legislation would not apply when the time off is for maternity or sick leave. The legislation may apply in situations where there is not a commercial rationale for individual 2's leave that would otherwise justify an individual not working in the business for a year yet continuing to receive a full share of the profit. In year five, the arrangements are back on a commercial footing and the legislation would not apply.

Example 15

This example illustrates a scenario that would be outside the “income shifting” legislation. No tax advantage is obtained and no income shifted despite one of the partners stopping work within the business. The division of overall income between partners keeps up with the changing level of labour contributed by each and thus reflects what would be expected in a normal commercial remuneration arrangement.

Individual 1 and individual 2 found a company. They are both involved building the business over a number of years before individual 2 stops working for the company. Individual 1 continues to work in the business and draws a market rate salary. Dividends are distributed equally to individual 1 and individual 2, as they are both joint and equal owners of the company.

The new legislation would not apply in this case because income has not been shifted. Individual 2 has helped to develop and build the business and would have capital in the company. Individual 1 is receiving a market rate return for their services to the company. The dividends received by individual 2 are a return on their investment.

Other Examples:

Example 16

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.

Individual 1 is the sole shareholder and employee of a PSC. The PSC enters into a non-commercial arrangement, through a contract to provide services, with a second company that is wholly or partly owned by individual 2. This arrangement enables individual 1, through the PSC, to reduce their income and allows income to flow to individual 2 through their ownership of the second company through the use of dividends. Individual 1 may have been trading through the PSC for a number of years prior to entering into this arrangement.

The legislation may apply in this situation if individual 1 is a non-commercial arrangement and income is flowing to individual 2, but this would depend on the individual facts of the case. A review of this situation by either individual 1 or HMRC should take account of everything that facilitates the income flow to individual 2. For example, the PSC entering into the contract with the second company should be regarded as individual 1 entering into an arrangement for these purposes. As long as the individual is party to relevant arrangements it would not matter that they were implemented through the medium of either a PSC or other form of service company.

Guide to the Family Business Tax legislation on “income shifting”

Example 17

This example illustrates a scenario that would be covered by the “income shifting” legislation. A tax advantage is obtained through an individual giving shares to other individuals and as a result foregoing income, over which they retain power to influence, that becomes taxable in the hands of the recipients.

Individual 1 owns all 100 £1 shares in the company. Individual 1 draws a market rate salary of £80,000 per year. In the year to 5 April 2008 the dividends paid were £60,000 after which the company had distributable reserves of £250,000. On 6 April 2008, individual 1 gives 40% of the shares to their four adult children. There are no other changes in the situation, but when dividends are declared 40% of them flow to the adult children who are chargeable at lower rates of income tax.

The new legislation would apply in this type of situation because income is being shifted from individual 1 to their children. Individual 1 still has the power to control and influence the level of income arising from the assets given.



PROFESSIONAL
CONTRACTORS
GROUP

About PCG

The Professional Contractors Group (PCG) is the not-for-profit trade association for freelance consultants and contractors in the UK.

The value of freelancing

One in seven workers in the UK choose to work for themselves and freelancing has become the preferred way of working for the very best talent in every sector.

Our aim is to win proper recognition of independent freelancers, who provide industry with a flexible workforce, generate wealth and make a valuable contribution to the economy.

Our members

Our members work in a wide variety of sectors, including information technology, oil and gas, transport, engineering, finance and banking, management consultancy, marketing, media, telecommunications, construction and pharmaceuticals.

We work to promote our members commercially and support their development, actively developing tools, services and relationships that will assist them. Our objective is to help members improve and enhance their business prospects and continually improve the professionalism of the freelance community and the way in which it is perceived.

Member benefits

We offer our members a broad range of services, including cover under our insurance policies, legal and tax helplines, comprehensive guides, draft contracts and regular events.

Representation

We represent freelance consultants and contractors in the UK on matters relating to regulations, taxation, economics, employment and other issues that affect them.

In seeking to exert influence, our policy team engages in direct discussion with senior Ministers and civil servants, participates in consultation exercises, forges relationships with unions and other organisations and produces a comprehensive range of research and policy papers. In line with our case law strategy, we also support a selection of cases for our members each year.

The photographs on the front cover feature PCG members, representing a wide range of disciplines, skills and market sectors.

For further information

www.pcg.org.uk

Professional Contractors Group Limited

Heathrow Boulevard, 280 Bath Road, West Drayton UB7 0DQ

t: 0845 125 9899 f: 0845 644 4105 e: admin@pcg.org.uk