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Policy Briefing: the “Income Shifting” Family Business Tax

Summary of proposals

In the 2007 Pre-Budget Report the Chancellor of the Exchequer announced his intention to prevent “income shifting”: this, he claimed, is the practice of splitting income between two people, often spouses or civil partners, in order to make use of the tax allowance of the lower-earning partner.

Family businesses have always been able to share out their profits among their owners. New laws will mean a tax hike for hundreds of thousands of family-owned businesses, a huge amount of bureaucracy and yet more uncertainty and complexity in the tax system.

Ten reasons why the Government should not introduce its new tax on family businesses

- 1) Where two people are exposed to the risk of a business failing, they should be entitled to share in the rewards if it succeeds: this has always been the case, and is not “unfair” at all.
- 2) Tax law and divorce law would become totally inconsistent: a spouse might be entitled to over half the value of a business in a divorce, but while married they may not be entitled to share any of the profits.¹
- 3) Such a measure would impose crushing burdens on thousands of jointly-owned businesses: it would oblige them to record and place a value on every contribution made to the business, which would be extremely time-consuming and often also extremely difficult.
- 4) New rules would inevitably be so complex that self-assessing a tax liability with any certainty would be impossible.
- 5) Taxpayers’ willingness to meet their obligations will fall: they would be unable to self-assess their liabilities with any confidence, so many would make a token effort at compliance and then just hope not to be investigated.
- 6) HMRC will not have the resources to enforce these rules across the board: they will create a lottery regarding who will be investigated and who will not.
- 7) Jointly-owned businesses are more successful: PCG’s survey data shows that businesses where two people are involved have higher turnovers than those with only one person, even if only one of those people is directly earning the fees.²
- 8) The Treasury has stated that “income shifting” runs counter to the principle of independent taxation: in fact, it is the natural consequence of independent taxation, which was foreseen and accepted when independent taxation was introduced.
- 9) The Government seems to think there is something wrong with spouses setting up “non-commercial” arrangements and wants to penalise them: in the real world, married couples enter into financial arrangements on the basis of being married to each other and it is wholly inappropriate to expect them to enter into “commercial arrangements”.
- 10) It is wrong to see dividends as simply being “income” - they are a return on risk and investment, and are not comparable to a salary.

Background: the Arctic Systems case

- These proposals are being developed after HM Revenue and Customs lost a tax case in the House of Lords (Jones v Garnett, more commonly known as the Arctic Systems case) which would have allowed them to tax thousands of jointly-owned companies more heavily.
- Arctic Systems Ltd is a small IT company owned by PCG members Geoff and Diana Jones: PCG supported them in defending themselves against the Revenue up to the House of Lords.
- The Government immediately announced its intention to legislate, in order to achieve “greater clarity in the law regarding its position on the tax treatment of ‘income splitting’”.
- The law was in fact made clear by the Arctic judgment, and there is no need for new legislation simply to achieve “clarity”.

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

² Applies to businesses with turnovers of over £60,000 pa
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