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Policy Briefing: the “Income Shifting” Family Business Tax

Introduction

The Government has issued draft legislation, intended for inclusion in the Finance Bill 2008, to place a new tax on what it calls “income shifting”. The result will be significant tax increases for hundreds of thousands of small family businesses.

At present, a business owned jointly by a married couple can distribute profits equally to each: this allows them to use up their tax allowances efficiently, and can create a tax saving.¹ This is a consequence of the independent taxation of spouses that was recognised and accepted by Parliament when it was introduced in the 1980s. Now the Government wishes to impose a tax increase on everyone who has set up a business in this way.

PCG believes that the proposals are unfair

- 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”.
- Profits are distributed as a return on risk: the Government fails to recognise that married couples are jointly exposed to the risk of their business failing, and is seeking to deny them a joint share in the rewards if they succeed.
- For years the Government advised people to set up businesses jointly when possible: now they are to be penalised for following the Government’s advice.
- The proposals clearly and directly discriminate against small business and in favour of big business: if a consultant is hired out by a large company, he will be paid for the work and the rest of the fee will go to the company as profit, which can then be distributed to shareholders in the usual manner. If a consultant took exactly the same contract with exactly the same client for exactly the same payment, but the consultancy happened to be one he owned with his wife, the dividends would be taxed more heavily than the dividends of the large company.

PCG believes that the proposals are unworkable

- The proposed measure will make it impossible for businesses to self-assess their tax bills. How can they value every single contribution made to a business accurately and with confidence? Businesses will be left perpetually looking over their shoulder in fear of an aggressive investigation by HMRC, in which they will have to prove that they have done nothing wrong.
- The Government claims that the new rules will not cost businesses anything to administer, and not cost HMRC anything to enforce: this cannot possibly be the case for such a complex and subjective set of rules.

PCG believes that the proposals are inconsistent with other areas of law

- Spouses are entitled to equal shares in the value of a jointly-owned business in a divorce.
- Spouses are entitled to equal shares in the proceeds, under Capital Gains Tax rules, in the event that a jointly-owned business is sold.
- Under the proposals, spouses will not be entitled to equal shares in the profits of a jointly-owned business while it is operational.

PCG believes that the proposals are not justified by the consultation paper

- Ever since the independent taxation of spouses was introduced in the 1980s, it has been common practice for married couples who go into business to set up the business jointly; the consultation paper fails to show that anything has changed since then to justify the new rules.

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

For further information on this subject or to receive a more detailed briefing, please email John Kell (john.kell@pcg.org.uk) or phone 0845 1259899