Income shifting

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In the *Pre Budget Report* in October 2007 the Government stated that it would introduce legislation to prevent individuals from arranging "their affairs to gain a tax advantage by shifting part of their income, from dividends to partnership profits, to another person who is subject to a lower rate of tax."[1]

The origins of this announcement lie in a long-running case which concluded in the House of Lords on 25 July 2007. Geoff and Diana Jones, co-owners of Arctic Systems, a small IT business, had used a device – commonly-called income-splitting or income-shifting – practiced by many couples to reduce their overall tax bill. Rather than take a large salary, the main earner diverts part of his income through the structure of the family business into their spouse's hands. As their partner is in a lower tax-bracket, this minimises the couple's liability. HM Revenue & Customs asserted that the Jones' arrangements contravened the 'settlements legislation': provisions in tax law to prevent settlements – generally speaking, a disposition, trust, covenant, agreement, arrangement or transfer of assets – being used to gain tax advantages. However, many in the accountancy profession took the view that the tax authorities were seeking to brand ordinary commercial decisions as artificial tax avoidance. The Lords found for the taxpayer, but the day after the judgement the Government confirmed it would introduce legislation to ensure that "individuals involved in these arrangements should pay tax on what is, in substance, their own income."[2]

These proposals proved controversial, and 186 Members signed an EDM urging the Government to reconsider its proposals.[3] In *Budget 2008* the Government announced that it was launching "a further period of consultation"[4] and then in the *Pre-Budget Report* in November 2008 confirmed that it was "deferring action" and would simply "keep this issue under review."[5] This note examines the background to the Government's initial announcement, the responses to it, and the recent decision not to introduce legislation.

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1 Cm 7227 October 2007 para 5.99
2 HC Deb 26 July 2007 cc 89-90WS
3 EDM 714 of 2007-08, *Income shifting*, 16 January 2008
4 HC 388 March 2008 para 4.69
5 Cm 7484 November 2008 para 5.103

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1 Family businesses and the settlements legislation

In spring 2003 several tax practitioners raised concerns that the Inland Revenue had amended its interpretation of section 660 of the *Income & Corporation Taxes Act (ICTA) 1988* – the 'settlements legislation' as it is commonly known – in its application to the transfer of shares in a family business between spouses.[6] (The Inland Revenue merged with HM Customs & Excise to form HM Revenue & Customs in April 2005.) Some felt that the Revenue was now taking a 'more aggressive approach' toward a tax planning mechanism whereby the main earner in a family business transferred shares to their spouse, which gave their partner a right to dividends. This enabled the couple to enjoy profits generated by the business treated as dividend income of the spouse, rather than the main earner's salary. Given the spouse was likely to be earning much less than their partner, there would be clear tax advantages in doing this.

An extract from one article written at this time is given below:

> It is common for tiny companies to have half-ownership of the shares by husbands and wives. The profits are paid partly as salary and partly as a dividend on the shares. Paying some of the dividends to the spouse keeping the books and acting as company secretary helps the main earner to reduce income and thus stay out of a higher tax bracket … The Revenue has started operating a section of the Income and Corporation Taxes Act which allows the income to be attributed to the person the taxman decides is doing most of the work. The Revenue's move derives from section 660A of the Act which in effect says transferring an income stream to a relative who does not pay for the privilege is merely a pretence, especially if the donor "maintains an interest". In one recent letter to a small business, the tax inspector said the wife's work as company secretary without pay was only a few hours a week, so half the dividend income she received from her 50pc ownership of the shares would be transferred to the husband. As a result, another £14,000 of tax was due ...
>
> Peter Vaines of Haarman Hammelrath suggested the campaign probably derived from legal cases *Young v Pearce* and *Young v Scrutton [1996]* which the Revenue won, though those were about preference shares. The legislation concerning spouses is when the gift is wholly or substantially a right to income, he explained. As a result, the point is indeed arguable on preference shares, which are in effect entitlements to income, but on ordinary shares "the arguments don't seem very good", he added. Ordinary shares "cannot be said to be wholly or substantially a right to income. The shares represent a bundle of rights and the right to income is not the most important."

[6] "Inland Revenue to make family businesses pay", *Times*, 15 March 2003; "All very unsettling!", *Taxation*, 13 March 2003

> In addition, unlike preference shares, the dividend is optional. In that case, "the taxpayer would have a very good argument". Francesca Lagerberg of accountancy firm Smith & Williamson agreed that "it doesn't tie in with the spirit of the legislation. The decision may be justifiable on preference shares, but ordinary shares carry duties and responsibilities." …
>
> The legal boundaries of this "settlements" legislation have never been tested, explained John Whiting of Price Waterhouse Coopers, despite being around since the 1930s. In addition, "it is an area that is not well understood". Accountants until now thought the settlements legislation did not apply when the husband gave shares to the wife because that was covered by the exemption in s660A(6) of the Act. "However the Revenue view is that this exemption does not apply because the shares are 'wholly or substantially a right to income'," … [says, Anne Redston of Ernst & Young]. Mr Whiting said owners of small businesses would not have been warned this danger was on the way. There has certainly been no easily available guidance on this, such as tax bulletins or press releases, and no tax cases which deal with the areas under attack. The Revenue has, however, promised to produce guidance on how it now thinks the rules should be applied.[7]

Apropos the last point made in this piece, one practitioner noted elsewhere that "commentators and authors on incorporation have long highlighted the need to be conscious of the settlements legislation when sole traders incorporate and subsequently want to pay dividends to a spouse ….[and] the point has long been addressed in what is now known as the Revenue's trusts, settlements and estates manual."[8] Indeed at the time the then Paymaster General, Dawn Primarolo, responded to a written question about this issue simply stating that, "the Inland Revenue has not changed its interpretation of sections 660A to 669 of the *Income and Corporation Taxes Act 1988*."[9]

Following representation from the Chartered Institute of Taxation (CIOT), the Revenue published a long article in April 2003, looking at situations where, in its view, the settlements legislation applied to non-trust situations involving individuals, companies and partnerships. Its conclusion was as follows:

> Whether or not the settlements legislation applies to an arrangement depends on the particular facts of the case. It is necessary to look at the arrangement as a whole. If there is a bounteous arrangement which effectively transfers income earned by one person to another resulting in a reduction in overall tax liability the arrangement may be liable to challenge under the settlements legislation.
>
> A purely commercial transaction or series of transactions at arms length is outside the meaning of 'settlement'. Most commonly the legislation will apply where individuals seek to divert income to members of their family or to friends. A good test of whether or not the legislation could apply is to consider would the same payments be made to a person who acquired shares in a company or a share of a partnership at arms length. Or whether income is being paid simply because the recipient is your spouse or child or some other individual you might wish to benefit.[10]

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[7] "Not for richer, only for poorer: running a family business may become even more fraught, thanks to a new stealth tax", *Daily Telegraph*, 10 March 2003

[8] "Why not enforce existing rules", *Accountancy Age*, 3 April 2003. The Manual is published on HMRC's site at: http://www.hmrc.gov.uk/manuals/tsemmanual/index.htm

[9] HC Deb 27 March 2003 c 341W

[10] "Businesses, Individuals and the Settlements Legislation", *Tax Bulletin*, issue 64 April 2003 pp 1015-6. Though the Bulletin is now discontinued, it is available: http://www.inlandrevenue.gov.uk/bulletins/index.htm

Many in the profession were strongly critical of the piece and of the Revenue's approach as a whole, and in September 2003 the CIOT made joint representation to the Revenue with the other accountancy institutes and the Federation of Small Businesses.[11]

At this time the Tax Law Review Committee published a report on the tax treatment of married couples in response to the Government's consultation on introducing a civil partnership scheme.[12] (Civil partnerships were introduced on 5 December 2005, and civil partners are treated in just the same way as married couples by the tax system.) Though the Committee were very much in favour of civil partnerships being accorded the same tax treatment as married couples, it suggested there was underlying confusion in the approach taken by the tax system to marriage. On the specific question of the settlements legislation, and its application to family businesses, it made a number of comments:

> **4.4. Settlements**
> The concept of a "settlement" in the Taxes Acts is an extended and complex one, with consequences spanning income, capital gains and inheritance taxes.
>
> For income tax:
>
> - "settlement" includes any disposition, trust, covenant, agreement, arrangement or transfer of assets, and
> - "settlor", in relation to a settlement, means any person by whom the settlement was made.[13]
>
> The income tax legislation on settlements comprises Part XV of ICTA 1988 (sections 660A to 694). It is currently proving highly controversial because of the following extension: "…a settlor shall be regarded as having an interest in property if that property or any derived property is, or will or may become, payable to or applicable for the benefit of the settlor ***or his spouse*** in any circumstances whatsoever."[14]
>
> Based on this extension, the Inland Revenue is seeking to apply the settlements' provisions to a number of common situations in which husband and wife both hold shares in a family trading company and dividends are paid to the wife.[15] The correct application of the tax concept of settlement is highly difficult, at the best of times; there is continuing technical doubt as to whether certain Court Orders commonly made on divorce in respect of the matrimonial home are settlements for tax purposes or not.[16]
>
> In modern times it might be considered questionable why an individual's spouse – including a separated spouse - should be particularly singled out for prejudicial treatment under anti-avoidance legislation. The tax concept of "connected person" is already very broad and could if necessary be extended to include unmarried partners

[11] "Tax attack puts family firms in jeopardy", *Guardian*, 11 September 2003. For a contrary view of the position see, "The Revenue is right", *Tax Journal*, 22 September 2003.

[12] The Committee was set up by the Institute for Fiscal Studies in autumn 1994 to ask whether the tax system was working as intended, efficiently and without imposing unnecessary burdens.

[13] *ICTA 1988*, section 660G(1).

[14] ICTA 1988, section 660A(2); emphasis added.

[15] Inland Revenue Tax Bulletin No 64, April 2003; analysed in, for example, *Taxation*, pp. 422-444 (17 July) and 477-479 (31 July).

[16] Mesher and Martin or "deferred charge" orders, for example, excluding one spouse for a period from the matrimonial home which will later be sold for the benefit of that or both spouses; the uncertainty arises because the judge, not the excluded spouse, is making the disposition. For a useful introduction, see the discussion by Professor J E Adams, *Marriage Breakdown*, chapter 40 in *Tolley's Tax Planning*, 2002-03.

> LTAHAW[17] as well as spouses and blood relations. Given the Inland Revenue's pursuit of married couples at the present time, if the definition of spouse here were extended to include partners in a civil partnership, many same sex couples in business together might be well advised to consider whether entering into a civil partnership might not be severely prejudicial to their joint tax position.[18]

An exchange of correspondence between the profession and the Revenue did not resolve the issue, as a press notice issued by the CIOT in November 2003 showed:

> In an unprecedented show of unity, the heads of the UK's leading tax, accountancy and business bodies have strongly criticised the Revenue's position on Section 660A, characterising it as a secret husband and wife tax. This obscure but important legislation is commonly known as the "husband and wife tax" because of its effect on small businesses. If left unchallenged the Revenue's controversial interpretation is likely to leave thousands of small business facing unexpected and hefty tax bills. Whilst the Revenue argues that only 30,000 companies are potentially at risk, the professional bodies believe the figure is much higher (bearing in mind the number of companies started in recent years) and that in any event even 30,000 is too high a number of businesses to be faced with uncertainty …
>
> "This is another stealth tax" said Mark Lee, Chairman of the ICAEW Tax Faculty. "The Revenue did not publish their interpretation of this legislation until 2001, and then only in a technical manual rarely read even by tax specialists. Nevertheless, they are applying their view for at least the last six years, which means many small businesses could face backdated and unexpected tax bills."
>
> This view was strongly endorsed by Tim Ambrose, President of the CIOT, who said "we believe that the Revenue have a legal and moral obligation to inform taxpayers of how the legislation is going to be applied. Their current approach is arguably a breach of human rights." The professional bodies have suggested a more pragmatic approach, which fits better with self-assessment. "We believe that taxpayers should normally self-assess on the basis that they are not within these rules, unless the opposite is clearly the case. The Revenue could challenge this self-assessment within the normal time limits, but the onus would be on them to prove their case" suggested Mr Ambrose. "We are particularly worried that small businesses, which are the engine room of the economy, are being distracted by this unfair tax at a time when they should be concentrating on the market recovery" said John Walker, Policy Chairman of the FSB.[19]

The Revenue published further guidance in *Tax Bulletin* in February 2004, focusing on the application of the settlements legislation to small companies and partnerships, and giving guidance on completing a self-assessment return where the legislation applied.[20] The piece also discussed a number of general principles; a short extract is given below – looking at two questions mentioned above: the position of ordinary shares (rather than preference shares), and the question of whether family arrangements should be treated differently:

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17 ["Living together as husband and wife" (LTAHAW). This is a technical concept, developed through social security case law and practice.]

18 Tax Law Review Committee, *Response to Civil Partnership: a framework for the legal recognition of same-sex couples*, September 2003 pp 15-16

19 CIOT press notice, *Tax, Accountancy and Business Bodies Criticise "Secret Husband and Wife Tax"*, 17 November 2003

20 "Businesses, Individuals and the Settlements Legislation – part II", *Tax Bulletin*, issue 69 February 2004 pp1085-1094

> **Shares**
> Much of the feedback we have received on the Tax Bulletin 64 article concerned ordinary shares and the rights that they carry. Whilst the rights and obligations associated with a share are relevant they are only part of the issue. We have not suggested that, for the legislation to apply, an ordinary share itself must be wholly or substantially a right to income. We look at the whole arrangement, as the legislation requires. The relevant questions are: What has been invested? What assets, trade, profession have been placed in the company and by whom? Who does what to earn the income of the company? Is the remuneration paid at a commercial rate for the job? Is someone getting a disproportionate return on the capital they have invested because of their relationship with the settlor? All these issues must be considered and if the shares are being used as a vehicle for diverting income then the legislation may apply.
>
> It has also been argued that as the shares in Young v Pearce [1996] STC 743, were preference shares, ordinary shares cannot also be caught by the settlements legislation. We do not accept that. The Young v Pearce case was determined on the facts in that case and the question whether the settlements legislation can apply to situations involving ordinary shares was not considered …
>
> **Family company/partnerships**
> We have been asked to reconsider the application of the settlements legislation to family/company arrangements as it has been suggested these involve special factors. We consider this is a misunderstanding of the settlements legislation which was enacted specifically to prevent individuals avoiding tax by diverting income to a family member or friend. An outright gift of money is a bounteous act but does not create a settlement. But an arrangement for one spouse to receive the other's income via dividends is caught by the settlements legislation. There is a substantial body of case law on "bounty" and the suggestion that the rules should be applied differently in a family situation is not consistent with that case law.[21]

In this article the Revenue noted that both this piece and its predecessor "[set] out the Inland Revenue's view of the way the legislation applies [although] that view is not accepted by many accountants and tax practitioners." In a piece in the *Independent* in December 2003, John Whiting and Anne Redston – both stern critics when the issue arose – were both quoted:

> The problem lies with interpretation of Section 660A of the Income and Corporation Taxes Act of 1988. The result is that all or most of the dividends from businesses jointly owned by husband and wife may be treated as the income of the higher earner - no matter how the company itself distributes the dividends between them - causing more earnings to trip into higher rate tax. The Revenue argues that dividend payments should broadly reflect the involvement of each partner in the business, and where they do not, the Revenue may treat the dividends as being paid to the higher earner. In many cases the Revenue is applying the interpretation back over the last six trading years - and charges interest on the unpaid tax …
>
> Many of [those couples affected] are now receiving bills of £20,000, £30,000 or £40,000, says John Whiting, tax partner with accountants PricewaterhouseCoopers and a former president of the Chartered Institute of Taxation. "It's handy cash for Gordon's coffers coming from small businesses," he adds. "It can be a couple of years' earnings … I believe at the minimum the Revenue is applying the rules differently. It has hit a lot of small businesses who did not know they were doing anything wrong and

[21] *op.cit.* p1086

neither did their tax advisers." He adds that if the Revenue's approach is correct it provides an almost impossible challenge for couples in completing their self-assessment returns, because they will have no idea what proportion of the spouses' dividends the Revenue will accept can be applied to the lower earner.

Anne Redston, tax partner with accountants Ernst & Young, says: "I think there are three problems. First, there are many people who think the Revenue is wrong technically. Second, even if they are right technically, they did not tell anyone and even if you were a specialist in this area you were unlikely to know because they said it in a journal published on the Web. And they only said in 2001 they were claiming back tax to 1994. My third problem is that it is very difficult for people to decide whether it applies to them. It's a nightmare for small businesses."[22]

2 The Arctic Systems case

In June 2004 a case came before the Special Commissioners which generated considerable interest in the profession and freelance consultancy groups: *Jones v Garnett*, or, as it came to be known, *Arctic Systems.*[23] A piece on the case in *Taxation* gives a very brief summary:

> When he was made redundant, Mr Jones decided to become a freelance computer consultant. He and his wife acquired Arctic Systems Ltd off the shelf, each being issued one ordinary share. He was the sole director, she was the company secretary. He generated the income of the company by working full time for clients, she worked for about four to five hours a week on administration. They both took low salaries and paid out the majority of the income of the company to themselves equally as a dividend.
>
> There were two points at issue. First, did this constitute a settlement (under the wide definition for income tax which includes 'arrangements') under which income was payable to the settlor's spouse (TA 1988, s 660A(2))? Second, if it was a settlement, was it excluded from charge by subsection 6, on the grounds that it was an outright gift from one spouse to another, which was not wholly or substantially a right to income?[24]

In September 2004 the Commissioners ruled in favour of the Revenue.[25] This decision was upheld in the High Court in April 2005, but overturned by the Court of Appeal in December that year.[26] Finally, in July 2007 the House of Lords also ruled in favour of the taxpayer. It is beyond the scope of this note to discuss the judgement at length, but in essence the Lords concurred that the agreement constituted a settlement, but was exempt from tax because Mr Jones' gift of an ordinary share to his spouse was *not* wholly or substantially a right to income. In his lead judgement Lord Hoffman said the following on this particular question:

> It is true that the value in the share arose from the expectation that it would generate income. But that is true of many shares, even in quoted companies. The share was not wholly or even substantially a right to income. It was an ordinary share conferring a

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[22] "Husband-and-wife tax hits small firms", *Independent*, 6 December 2003

[23] "Small business await result of tax test case", *Financial Times*, 14 June 2004 & "Section 660A appeal", *Taxation*, 24 June 2004.

[24] "Geoff Jones and the lost Garnet(t)", *Taxation*, 2 August 2007

[25] *Jones v Garnett* (Decision number spc/00432, 28 September 2004); "Tax rule spells anxiety for family businesses", *Financial Times*, 8 October 2004

[26] [2005]EWCA Civ 1553 15 December 2005

> 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. The ordinary share is different from the preference shares in *Young v Pearce* (1996) 70 TC 331, which conferred nothing except the right to 30% of the net profits before distribution of any other dividend and repayment on winding up of the nominal amount subscribed for their shares. Those shares were substantially a right to share in the income of the company.[27]

The judgement lead in turn to the Government's statement the next day, which is reproduced in full below:

> **The Exchequer Secretary to the Treasury (Angela Eagle):** The Government acknowledge the judgement given by the House of Lords in the Jones v Garnett (Arctic Systems) case. The Government are 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.[28]

Writing in *Taxation*, one practitioner noted that the House of Lords' "decision in itself means that most of the existing HMRC guidance, as outlined in its booklet, *A guide to the settlements legislation for the small business adviser*, becomes defunct. This guidance was issued in 2004 and never updated for subsequent decisions in the *Jones v Garnett* case."[29] Notably, following the decision in favour of the taxpayer by the Court of Appeal in December 2005, HMRC issued a statement on its website a few months later stating that it would be "premature to reconsider [this] guidance" and that the "correct time to do that is when the case has been finally resolved", even though "the Court of Appeal judgement represents the law as it now stands."[30] In April 2008 the Government answered a PQ on the number of tax assessments that had been held in abeyance pending judgement in the Arctic case:

> **Mr. Arbuthnot:** To ask the Chancellor of the Exchequer how many Inland Revenue assessments were held in abeyance pending the outcome of Jones v. Garnett; what proportion of those assessments have been abandoned following the decision in that case; and if he will make a statement.

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[27] *Jones v Garnett* [2007] UKHL 35 para 30

[28] HC Deb 26 July 2007 cc 89-90WS

[29] "Arctic chill", *Taxation*, 9 August 2007

[30] Statement issued on 24 March 2006. The text can be seen at: http://www.hmrc.gov.uk/trusts/jonesvgarnett-further-advice.htm (ret'd 2/2/2009)

> **Angela Eagle:** The information requested is not available. However, cases in abeyance pending the court judgment have been disposed of in three different ways. Cases with facts in line with the Jones case were closed down very quickly. Some others have been settled with tax being payable. And there are some cases where the arguments have not been affected by the terms of the court judgment some of which are still being resolved.[31]

In a second piece which appeared in *Taxation* at this time, Mike Truman, the magazine's editor, noted that "the biggest complaint from the profession during the course of Arctic Systems was that practitioners were having to make long-term decisions about the way that their clients' affairs should be organised without knowing what the tax position would be." He suggested that this uncertainty might indicate the department's general attitude to this form of tax planning:

> Why did HMRC not announce in 2006 that, in view of the conflicting decisions and arguments already raised in the case, they intended ultimately to legislate in order to create clear liabilities, and that the discussion about what the legislation should say would take place at the same time as the appeal process, so that legislation could be introduced as soon as possible after it finished? … I can imagine that HMRC might have thought that to start making proposals about how the legislation should be changed before the case was final would be to invite accusations of prejudging it, but it is hard to see how such an argument would have held water. It is common for judgments in cases on avoidance to start their review of the legislation with the comment that the law has subsequently been changed, and no-one finds that surprising …
>
> The other, rather more unpalatable, option is that uncertainty actually suited HMRC. The tone of the ministerial statement makes it clear that they consider this sort of arrangement to be unfair tax avoidance … If companies splitting income was considered to be tax avoidance, perhaps the best incentive that advisers could be given not to stray from the commercial path was to leave complete uncertainty about how any change was to be effected, thus forcing them to be conservative in the recommendations they made to clients? …
>
> The D'Arcy case[32] showed that approaching [tax avoidance schemes which are based on purely artificial business transactions] by blocking off each loophole as it arises may be ultimately impossible, because each set of anti-avoidance provisions creates more interactions which themselves may give rise to further loopholes … In such artificial cases, I have no problem with HMRC acting in a way which, without abusing their powers, makes life difficult for the scheme providers. Those who rely on a step-by-step interpretation of the law should not be surprised, for example, when the mechanics of their schemes are taken apart and examined step-by-step to see whether every nut and bolt was firmly screwed together.
>
> But Arctic Systems was not such a case. It was a decision about how a business should operate which had lasting commercial implications, Mr and Mrs Jones and their accountant undertook the perfectly proper process of looking at the choices on offer and choosing the one which gave the lowest tax liability. We all make choices, as households, about who will make the charitable donations, the pension contributions,

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[31] HC Deb 24 April 2008 c2186W

[32] [*Revenue and Customs Comrs v D'Arcy* [2007] EWHC 163 (Ch). The case involved in extremely convoluted arrangement for buying and reselling gilts, the sole aim of which was to create an allowable loss for the taxpayer, a recruitment consultant in the City, to offset against tax on their £2.1m salary. For commentary see, "It's the clients", *Taxation*, 1 March 2007]

> who will own the income producing assets, and so on. That is not artificial tax avoidance; that is organising our affairs, in a real rather than an artificial way, to make the best and proper use of the opportunities available to us.
>
> If it is the case that HMRC's attitude to Arctic Systems (and the legislation that was going to be needed after it) was based on treating it as artificial avoidance and therefore to extend the uncertainty, then it seems to me to have been an own goal. There are going to be many views about where the line should be drawn between artificial, unacceptable, avoidance and legitimate tax planning, but to call this case avoidance is to deny that such a line exists at all. Unless HMRC are prepared to see the distinction, it is hard to see how any consensus with the profession can be reached.[33]

In her contribution to the Lords judgement, Baroness Hale noted the variety of ways in which married couples could run their businesses, only one of which accorded with what the tax authorities wished to prevent:

> When a husband and wife team set up a family business through the machinery of a private company in which they each have an equal number of shares, they may have clear expectations of what the future will hold or they may not. If combined with low salaries and high dividends, as things stand at present, the arrangement will always result in lower national insurance contributions and lower income taxation.
>
> But as I understand it, the Revenue is anxious to catch only one of the following examples:
> (i) they may expect that each will make a contribution to the company's earnings of roughly equal financial value;
> (ii) they may expect that each will make a contribution which is equal in terms of effort but (not least because of historic discrimination between the price of different kinds of services in the market place) unequal in terms of earnings for the company;
> (iii) they may expect that each will contribute what they can but that those contributions will vary over time, perhaps because of personal factors such as illness or child rearing, perhaps because of changes in the business and its market; or
> (iv), as here, they may expect that one will contribute the work which brings in the money from outside while the other will contribute the limited but necessary ancillary services to make that work possible but bring in no independent money from outside.
>
> There are many variations and permutations between these possibilities.[34]

One practitioner noted that this would make it very hard to draft targeted legislation: "the difficulty is going to be that very fine distinctions have to be made to avoid ensnaring those with whom HMRC has no problem … and, almost as importantly, avoiding a situation where all small companies are potentially to be challenged."[35] The Chartered Institute of Taxation issued a joint press notice with the Institute of Chartered Accountants concerned that the Government should not 'rush' to legislate; part of this is reproduced below:

> Both professional bodies are hoping that HM Treasury and HM Revenue & Customs will fully consult and listen to all interested parties before creating tax law that increases uncertainty further and puts yet more obstacles in the way of small businesses … Francesca Lagerberg, Chairman of the Technical Committee of the

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[33] "Changing horses", *Taxation*, 30 August 2007
[34] *Jones v Garnett* [2007] UKHL 35 para 67
[35] "Arctic Systems", *Tax Journal*, 6 August 2007

ICAEW Tax Faculty, says: "The Government is looking to review situations where family members are involved together in a business. It appears that the tax authorities will seek to separate out 'commercial' situations from those where it believes dividends are being passed to lower rate taxpayers primarily to keep down the tax bill. The reality is that most businesses do not fall into such neat categories. There is a danger that rushed legislation will result in unworkable legislation, plunging thousands of taxpayers into yet more uncertainty about their tax position. There is no 'quick fix' formula that we think could work. There is now an urgent need for full and detailed consideration of the small business tax regime, which should include a detailed understanding of the businesses and the issues involved and full consultation, which should be completed before any measures are announced."

> Andrew Hubbard [CIOT Vice-President] adds: "We can understand why the Government would want to review the structural basis of small business taxation. There are anomalies in the current system and we would support reforms that more closely linked taxation with the underlying economic activity rather than with the legal form of that activity. But it is difficult to see how there can be a proper and open debate and consultation if the outcome has been pre-determined."[36]

As noted, the Government confirmed it would introduce legislation in the Pre Budget Report, published on 9 October 2007:

> The Government believes it is unfair that some individuals arrange their affairs to gain a tax advantage by shifting part of their income, from dividends or partnership profits, to another person who is subject to a lower rate of tax. The Government will be launching a consultation shortly on draft legislation to prevent such income shifting, with the intention that this legislation will take effect from 2008-09. The Government aims to ensure, through consultation, that only arrangements intended to reduce tax, rather than commercial arrangements, are affected by this legislation and that the administrative burdens of the legislation are minimised.[37]

It was estimated that these provisions would raise £260 million by 2009-10.[38]

3 Consultation on proposals : December 2007

On 6 December 2007 the Government published a number of consultation documents, including one on its proposals to tackle income shifting:

> The Pre-Budget Report set out the Government's view that income shifting - through which one individual can artificially shift part of their income to another person who is subject to a lower rate of tax - leads to unfair outcomes. Comments are invited on draft legislation, and accompanying guidance. The legislation would apply only where a tax advantage is gained through non commercial arrangements and where the shifted income is in the form of a company distribution or share of partnership profits. The legislation aims to ensure that genuine commercial transactions are not affected, and that administrative burdens are minimised.[39]

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[36] CIOT/ICAEW press notice, *Caution urged in response to Arctic Systems decision*, 26 July 2007
[37] Cm 7227 October 2007 paras 5.99-100
[38] *op.cit.* p 164
[39] HM Treasury press notice 139/07, 6 December 2007

The deadline for responses was 28 February 2008.

The paper gave two simple examples of income shifting by means of a company structure, and a partnership structure:

> 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 a 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.[40]

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

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

[40] *Income shifting: a consultation on draft legislation*, December 2007 p4

> 1.15 Additionally, the tax paid by individual 1 and individual 2 must be less than it would have been had they 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 …
>
> 1.19 The effect of the legislation proposed is that where a distribution that has been 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.

The paper conceded that "for a minority of businesses there may be concern that distributions from the business fall within the scope of the legislation" and listed a series of factors that one would have to consider "to establish the correct treatment in these situations":

- Is one individual in a position to shift income, with power to control or influence any arrangements? In other words, can one individual 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?

As "the answers to these questions will depend on the facts of each case", the paper also provided the draft of detailed guidance which "sets out ways in which the Government believes that business owners and their advisers could establish whether income shifting has taken place, including factors which may be taken into account when considering the contribution of each individual to the business."[41]

Mike Truman, editor of *Taxation*, argued this approach was fundamentally flawed:

> The legislation itself is just under 700 words long. Unfortunately it is also vague and potentially excessively wide-reaching. It therefore has to be explained and cut down in its effect by guidance, which runs to a total of over 9,000 words in the current draft, and will no doubt only get longer as further issues are raised. The guidance contains, at present, 17 separate examples as its final section, and there are four further examples in the rest of the text. Now, on the one hand it is useful to have the practical implications of legislation clearly shown by means of examples. But on the other, how obscure and unworkable do 700 words of legislation have to be in order to need 21 examples to explain what they actually mean?[42]

In a piece he wrote some months later Mr Truman suggested, "would it not make more sense to ask whether trying to prevent income shifting makes sense?":

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[41] *op.cit.* pp5-6
[42] "Unnecessary arboricide", *Taxation*, 14 February 2008

> In the vast majority of cases, income shifting such as this occurs because a couple who are living together try to rectify the injustice caused by our inflexible system of independent taxation. What is the logic for saying that spouses can transfer IHT nil rate bands on death, and that tax credit claims have to be based on joint income, but insisting on seeing a couple as two unconnected taxpayers when calculating their income tax liability? The ability to file a joint return with combined allowances and rates is common in many other countries, and means that the fault line of income shifting simply does not arise. So why do we insist on attacking the symptom rather than dealing with the root cause?[43]

One of the practical examples provided in the paper's draft guidance was to show how the specific circumstances of a case might be crucial in determining whether it fell under the income shifting rules or not:

> B.109 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 individual 2. The trading profits for year four are £80,000, with each partner receiving £40,000. In year five, individual 1 returns to work for the business. The business again makes trading profits of £80,000, which continue to be shared equally.
>
> B.110 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.[44]

One commentator writing on this issue noted that "it is not clear when [a spouse's] absence from work due to childrearing activities ceases, if ever, to be non-commercial. When or if [the couple involved] or their accountant, if not HMRC, decide that the pair have fallen foul of income shifting rules is not really clear cut either." They also noted that any investigation by the authorities into a couple's arrangements would require "evidence of who did what and when" even though "it is fair to assume that it is unlikely that these details will be preserved when one person is working irregular hours and performing different tasks within the business."[45]

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[43] "Faultlines", *Taxation*, 25 September 2008

[44] *Income shifting: a consultation on draft legislation*, December 2007 p29

[45] Nichola Ross Martin, "Income shifting proposals and problems", *AccountingWeb.co.uk*, 8 February 2008

The Institute for Directors argued that the examples provided in the consultation document were "simplified, and give no real conception of the difficulties that are likely to arise in practice. The proposed legislation must be tested on real examples, chosen by tax practitioners as likely to give a fair idea of the difficulties and not chosen by officials who wish to present the legislation as workable, before it is introduced to Parliament."[46] The Institute of Chartered Accountants agreed with this point: the examples "do not take into account the real complexities of most businesses. Many spouses do not have formal meetings to discuss their business arrangements, they just have their own way of working together. Owner-managers will need to try and establish whether their existing dividend or profit allocation is still acceptable and for many businesses this will be no easy task."[47]

In their immediate response to the consultation paper, the Chartered Institute of Taxation raised concerns about applying the new rules in practice:

> The legislation imposes an arm's length test and requires taxpayers to work out how much income they have 'foregone' by making a comparison with how the business would have operated had everything been done by independent third parties operating on a fully commercial basis. In theory this might seem fair, but the reality is that family businesses do not and cannot possibly operate on a fully arm's length basis. One spouse might be the main income generator but he/she may well be totally unable to run the business without the full support of the other. Measured purely in hours that spouse's input may not appear to be significant, but that is not the reality of the situation. The support of the spouse may well be the difference between the business succeeding and failing.[48]

On 11 January, the CIOT published an open letter to the Treasury, concerned as to whether there was "a real willingness to listen to our concerns or to understand the issues":

> We do not dispute that the position of small business tax is unsatisfactory and in need of reform. But we have consistently argued for a proper, thorough review - something that was in fact started a few years ago - rather than sticking plaster solutions of the sort now being attempted. At the moment, the same level of economic activity can give widely different tax outcomes, depending on the legal structure that has been adopted. These proposals will not change that position.[49]

The Institute published a detailed response in February, noting that, "the length of our comments is a reflection of the volume of comments we have received on this subject from ordinary members." One of its main criticisms was that the Government's proposal "merely tackles the shifting of income at the lower level of the market, and may seem unfair to those caught when they see that the very wealthy can legitimately 'income shift' through, for example, the movement of capital (whether property, quoted shares or other sources of income) between related parties." In its conclusion it suggested "that these proposals will impose undue burdens, out of proportion with any potential tax take, on owner manager businesses and therefore on the economy as a whole."[50]

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[46] IoD, *Income shifting: a consultation on draft legislation*, 22 January 2008 para 18
[47] ICAEW press notice, *ICAEW warns that new income shifting rules will lead to confusion*, 6 December 2007
[48] CIOT press notice, *Grave concerns over draft legislation on income splitting*, 6 December 2007
[49] CIOT letter to Financial Secretary, 11 January 2008
[50] CIOT, *Income Shifting: a consultation on draft legislation*, 28 February 2008 paras 1.4, 3.3, 8.1

A similar case was made by Richard Murphy, an accountant and commentator, who writes for Tax Research LLP. In a long paper on this issue, he proposed that the consultation be extended by a year, to allow for a much wider consideration of income shifting. Mr Murphy gave several examples of where income shifting occurs elsewhere in the tax system:

> The practice of income shifting is commonplace elsewhere in the tax system and is not restricted to partnerships and returns form privately owned companies. Other forms of income shifting commonly undertaken include:
>
> 1. The sharing of investment income between spouses, a situation that is so commonplace that equal sharing is assumed to be the default position by HM Revenue & Customs when more than one person is named as the recipient of investment income irrespective of evidence of ownership of the assets giving rise to that income, especially within a marriage or civil partnership. This form of income shifting is therefore specifically endorsed by HM Revenue & Customs unless strong evidence to the contrary can be given by the taxpayers involved. This position is directly contrary to that assumed by the proposed legislation and no justification for this is given in the consultation paper.
>
> 2. Income is shifted to companies and trusts to take advantage of lower taxation rates and in many cases this either receives official endorsement or is not subject to sanction. This is particularly true if the income in question arises from a capital asset rather than from human endeavour.
>
> 3. Income is converted into capital to take advantage of the lower taxation rates and additional allowances available for capital gains, and whilst anti-avoidance legislation to prevent such practice does exist it seems to be sparingly used to tackle such practices.
>
> 4. Capital assets are transferred between partners in a marriage or civil partnership for the purpose of exploiting lower rates of taxation and the utilisation of allowances for capital gains purposes and the practice is officially sanctioned within taxation legislation and never subject to challenge by HM Revenue & Customs.
>
> 5. Earned income is recategorised as investment income through the use of the medium of a limited company and the process is only rarely challenged where the activity giving rise to the income had commercial substance even if the resulting return on capital is wholly unrealistic. National insurance charges are blatantly avoided as a result. For the purposes of this submission national insurance charges are considered to be taxes.
>
> None of these means of income shifting are tackled within the consultation paper to which this submission refers and there appears no intention to do so. As a result the consultation paper lacks credibility because it does not address the issue of income shifting to which it claims to refer.[51]

In their response the CBI also proposed a year's delay in any changes, reiterating the point that "income splitting has long been accepted in relation to investment income [and] in principle, income shifting by family businesses is no different." They went on to argue:

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[51] Tax Research, *Income shifting: a consultation on draft legislation - submission to HMRC*, January 2008 pp5-6 At: http://www.taxresearch.org.uk/Documents/HMRCIncomeShifting.pdf

> For most owners of small businesses these proposed obligations would be extremely onerous, requiring them to obtain expensive professional advice in order to ensure their compliance, and the additional burden would be disproportionate to the potential revenue yield. Valuation of individuals' contributions to a business would be particularly difficult and subjective, inevitably leading to disputes in many cases. This would completely contradict the Government's stated aims of simplifying the tax system, encouraging entrepreneurial activity and fairness.[52]

Finally, the issue was touched on in one of the papers submitted as part of the ongoing review of the UK tax system – the 'Mirrlees Review' – being undertaken by the Institute for Fiscal Studies.[53] In March 2008 Claire Crawford (Institute for Fiscal Studies) and Judith Freedman (University of Oxford) published a study of the taxation of small businesses, which commented on the Government's proposals for tackling income shifting as follows:

> The proposals in the consultation document [issued in December 2007] would require the parties and ultimately the courts to evaluate whether income has been foregone by one individual in favour of another. The proposed test is complex and fact dependent, leading to justified criticisms that it would be heavy in compliance and administration costs and yet would probably raise little revenue. Extra-statutory guidance is looked to as the solution but this is unsatisfactory. The tests involve looking at the market value of work done but, as pointed out by Redston (2007),[54] raise very difficult questions of the value of each person's work, balancing value against volume of work done, balancing work done with capital contributions, and accounting for changes in the fact patterns over time.[55]
>
> There are many interacting issues to consider here. This is a question that needs addressing in a holistic way, looking at the rules on family taxation, small business taxation and capital transfers between spouses in the round. An outright gift of other types of income bearing property may generally be made to a spouse, so that investment income may be split in this way. The Government's objection is to splitting what is perceived to be the equivalent of labour income, but where the equity lies depends upon whether the comparator is truly labour income or investment income. The fundamental issue is once again that income from labour is being recharacterised as income from capital.[56]
>
> A system which treated all the income from companies in the same way as labour income (unless it represented a return to capital) would remove part of, although not all, the advantage of income splitting, since some of the advantage lies in being able to use the personal allowances and lower personal income tax bands. To deal with this, it would be necessary to consider the nature of independent taxation of spouses and civil partners and the role of their personal allowances. It would be possible to make their allowances and even their lower rate bands transferable to their partner, but this would bring other problems. It is not clear that it is appropriate to try to prevent the use of

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[52] Confederation of British Industry, *Response to the consultation on the Government's proposals on income shifting*, February 2008 pp 1-2

[53] Details of the review are given on its site: http://www.ifs.org.uk/mirrleesreview/index.php

[54] Redston, A. (2007), "Income Sharing: The Nelsonian Option", *British Tax Review*, No. 6, pp. 680-686

[55] It is understood that similar tests operate in other jurisdictions such as the USA, Netherlands and Sweden, but that there are operational difficulties in all these and that such a test is likely to be of value only in extreme cases.

[56] Redston (2007) argues that it is not right to compare the small businessman and the employee in tax terms. 'One could just as easily argue that [small business proprietors] should have paid holidays and fixed working hours. With respect, these conditions have nothing to do with the tax system, whereas rates of tax clearly do.'

these allowances through a complex business tax measure which is guaranteed to alienate small business owners.[57]

4 Recent developments

On 16 January 2008 Robert Smith put down an early day motion urging the Government to reconsider its proposals on income shifting:

> That this House notes with concern the proposals for a new tax on income shifting; is aware of the disquiet expressed at the proposals by small businesses, the self-employed, freelancers, accountants and other affected parties; is concerned that the new tax will make it impossible for jointly-owned businesses to self-assess their tax liability with any certainty; observes that ever since the introduction of the independent taxation of spouses, it has been standard practice for married couples to own businesses jointly, that this was recommended by the Government for many years and that people who followed this advice now face being penalised; is concerned that the proposals are in direct conflict with the Government's stated aim of encouraging enterprise and small businesses; observes that the new proposals will be inconsistent with divorce law and capital gains tax, so that spouses will be entitled to an equal share of the value of a business when they divorce, or of the proceeds from it when sold, but not of the profits while it is operational; and urges the Government to reconsider its proposals ahead of the Budget.[58]

In a piece on 7 February the editor of *Taxation*, Mike Truman, advised readers to lobby their Member to sign the EDM:

> In the midst of all the furore [the failure of HMRC's online self-assessment service on 31 January, the deadline for filing returns], the date of the budget was announced as 12 March. Does anyone seriously think that the comments submitted to the consultation on income shifting, which ends on 28 February, is going to be reflected in what the Chancellor says less than two weeks later? There has been a stubborn refusal in the Treasury to see such husband and wife companies as a legitimate use of the principles of independent taxation, albeit that no logical reason has ever been provided as to why those who make their income from capital should be allowed to split it for tax purposes, but those who make it from labour should not. We haven't campaigned on this issue, but I'm beginning to think it is time that we did. Fortunately there is an Early Day Motion in Parliament that we can encourage you to support, the wording of which can be found here …
>
> Our experience with the 'No to November' campaign was that the tipping point seemed to be around 100 signatures, particularly if they came from all parties[59] … Again, our experience is that it is better NOT to provide you with a pro-forma letter, because MPs are more likely to respond to individually composed letters, but the comments above

[57] Claire Crawford & Judith Freedman, *Small business taxation: a special study of the structural issues surrounding the taxation of business profits of owner managed firms*, IFS March 2008 pp 21-22. At: http://www.ifs.org.uk/mirrleesreview/press_docs/small_businesses.pdf

[58] EDM 714 of 2007-08, *Income shifting*, 16 January 2008

[59] [In 2006 the Government proposed that the deadline for filing tax returns should be 30 November after the end of the tax year, not 31 January as it is now. There was a extensive campaign against the new November deadline; 115 Members signed EDM 2262 of 2005-06 opposing the change. In July 2006 the Government announced that 31 January would remain the deadline for online returns; paper returns however now have to be filed by 31 October for the 2007-08 tax year and beyond.]

> might be useful, and the EDM itself refers to the contrast with the position on divorce. You might also want to point out that the EDM does not commit the MP to any particular position on the eventual solution, just to the need for a rethink.[60]

In all 186 Members signed the Motion.

In an editorial before the Budget the *Financial Times* argued that the Chancellor should "do nothing", as "damage has been done by constant change to the tax system":

> In April, a blizzard of tax changes announced last year will come into effect: restructured rates of income tax, a uniform capital gains tax rate of 18 per cent, higher tax on non-domiciled residents and plenty more. What Britain needs is a rest from all the changes … Bad idea number one is legislation to stop family companies from paying wages or dividends to a spouse in order to take advantage of their lower tax band. There are at least three objections to this idea. First, the bureaucracy of measuring each partner's contribution to a business will be massive. Second, it is ludicrous to force a married couple to deal at arm's length. Third, dividends are not wages, and to bundle them together violates the independence of limited companies.[61]

In *Budget 2008* the Government announced that it would consult further on provisions to tackle this problem:

> 4.69 The Government firmly believes it is unfair that some individuals can arrange their affairs to gain a tax advantage by shifting part of their income to another person who is subject to a lower rate of tax. The Government considered the responses received to the recent consultation and believes that a further period of consultation will ensure that the legislation in this area provides clarity and certainty for businesses and their advisers. The Government now intends to introduce legislation through Finance Bill 2009 and will not enact legislation effective from 6 April 2008.[62]

This move was widely welcomed;[63] writing in *Taxation* one practitioner noted, "we should be grateful that the Treasury has listened to its consultees and taken the sensible step of putting the proposals on ice pending further discussions."[64] David Drew put down an EDM on this issue supporting the Government's decision;[65] Robert Smith put down an EDM amending this, including the suggestion that the Government should "drop the proposals altogether if the forthcoming round of consultation shows that they ultimately cannot be made to work."[66]

When the Treasury Committee took evidence on the Budget, the Chairman, John McFall, raised the issue with John Whiting, from PriceWaterhouseCoopers and the CIOT:

> **Q115 Chairman:** The Chartered Institute of Taxation describe the income shifting rules as "a sticking plaster solution which did not address the real structural problems inherent in the ways that small businesses are currently taxed." Do you agree with this

60 "Treble trouble", *Taxation*, 7 February 2008

61 "Editorial: Britain needs a do-nothing Budget", *Financial Times*, 7 March 2008. See also, "Pressure for anti-avoidance rethink", *Financial Times*, 1 March 2008

62 HC 388 March 2008 para 4.69. At this time it was still estimated that the proposals would raise £260 million in a full year (HC 388 March 2008 p112). This estimate is for the tax year 2010-11

63 For example, "Reprieve for family businesses", *Financial Times*, 13 March 2008; CIOT press notice, *No rabbits in sight*, 12 March 2008; ICAEW Tax Faculty press notice, *Income shifting*, 12 March 2008

64 "Income shifting shifted", *Taxation*, 13 March 2008

65 EDM 1195 of 2007-08, *Income shifting and the future of small business taxation*, 17 March 2008. The motion attracted 30 signatures.

66 EDM 1195A1 of 2007-08, 19 March 2008. This attracted 13 signatures.

> assessment? Should the Government widen the consultation on income shifting to address these concerns?
>
> **Mr John Whiting** : I confess I wrote that phrase … [and] I will stick with it. Our preference would undoubtedly be that there is a good consideration to take the opportunity to have a wide-ranging review of how a small business activity, whether you are carrying it on as self-employed, small partnership, small company, is taxed. You might also sweep into this a read-across to employees because a lot of it just comes from the structural differences that you have, and to put an income shifting sticking plaster on to something we do not really know what we are aiming for is surely not the right way forward; better to have a proper review.[67]

Subsequently John Thurso raised this with the Chancellor when he appeared before the Committee:

> **Q415 John Thurso:** At paragraph 4.69, the Red Book states, "The government firmly believes it is unfair that some individuals can arrange their affairs to gain a tax advantage by shifting part of their income to another person." Why is it unfair?
>
> **The Chancellor, Alistair Darling:** If you have two people who are employed, they pay through the PAYE system and they have no choice about it. It just comes off at whatever rate is applicable. What is unfair is if you get a husband and wife, the husband is doing all the work and the wife does not make a contribution to the business and she can utilise her tax advantage in a way that just would not be open to anybody else.
>
> … [Q422] … Up until last summer when we had this court case, I think it was generally understood that if somebody was working, making a contribution, they could be fairly rewarded for that. What I readily accept, which is why we have delayed this, is that it is quite difficult to legislate for it. What I am very sure about is that if we do not address this problem we are going to lose more and more tax. More and more people will take advantage of that and the burden will fall on people who have no choice but to pay their tax.[68]

In its report the Committee noted its concern that "directors in other types of business were not required to justify their salary based on the work they had undertaken and that the draft legislation appeared to place an unfair burden on family business." It went on to conclude:

> We welcome the Chancellor of the Exchequer's decision to undertake a further consultation on the issue of income shifting. However, we are concerned that this proposed legislation would place an additional tax burden on small businesses and we note that it caused widespread concern during the previous consultation period. We recommend that the terms of the consultation be widened to constitute a full review of the principles of small business taxation to ensure that the taxation system rests on practical, workable rules for the small business community.[69]

In July the CIOT published its proposals for Budget 2009, including a suggestion for "a timely review of small business tax." On income shifting the Institute suggested that "the proposals be quietly dropped":

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[67] Treasury Committee, *Ninth report: The Budget 2008*, 7 April 2008 HC 430 2007-08 Ev20

[68] HC 430 2007-08 Ev56-7

[69] HC 430 2007-08 para 97

> We are still unable to understand why the Government has highlighted one form of income shifting for special treatment, where those affected most would generally be small business owners earning modest incomes and would have significant compliance costs with often little or no change in the Exchequer's tax revenue.[70]

The Institute's remarks were quite prescient. Although the Chancellor did not mention the issue in his Pre-Budget statement to the House on 24 November, the *Pre-Budget Report* noted the following:

> The Government firmly believes it is unfair to allow a minority of individuals to benefit financially from shifting part of their income to someone else who is subject to a lower rate of tax, known as income shifting. The Government has consulted on this issue but, given the current economic challenges, the Government is deferring action and will not bring forward legislation at Finance Bill 2009. The Government will instead keep this issue under review.[71]

In a short press notice the CIOT welcomed the announcement:

> The Chartered Institute of Taxation (CIOT) welcomes today's announcement that the Government is not to proceed with the income shifting legislation and continues to recommend that the Government reform of the way in which small businesses are taxed. Andrew Hubbard, CIOT Deputy President, says: "The current system for taxing small businesses is riddled with anomalies and inconsistencies and is need of a radical overhaul. But the income shifting regime would have made matters worse. It would have created a huge administration burden on all small businesses, would probably not have brought in significant additional taxation revenues and would have been a massive distraction at a time when businesses need to devote all of their energies to managing through the economic crisis."[72]

In their response to the PBR, the Institute of Chartered Accountants noted, "given the economic circumstances, the deferral of income shifting looks sensible and pragmatic" – though it went on to note that "this issue has not gone away: the proposed increases in NIC will inevitably focus attention again on the differences between operating a business through a company or an unincorporated structure."[73] In evidence to the Treasury Committee, John Whiting at PriceWaterhouseCoopers observed, "income shifting has been deferred in line with many representations showing how complex the proposals were" so that "one welcome note that this PBR strikes is to show the value of good consultation."[74]

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70 CIOT, *Budget 2009 – CIOT representations*, 18 July 2008 para 8.4-5

71 Cm 7484 November 2008 para 5.103. There was some limited press coverage of the decision (for example, "Family firms win income-shifting reprieve", *Daily Telegraph*, 25 November 2008).

72 CIOT press notice, *Income shifting announcement: CIOT response*, 24 November 2008

73 ICAEW (Tax Faculty), *Pre-Budget Report 2008*, December 2008 p4. The Government has proposed increasing the rate of NICs for employees, employers and the self-employed by ½ a percentage point from April 2011 (Cm 7484 November 2008 para 5.8).

74 *Second report: Pre-Budget Report* 2008, 28 January 2009 HC 27 2008-09 Ev 75