AN ANALYSIS OF THE PROPOSED LEGISLATION TO COUNTER 'INCOME SHIFTING'

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Introduction

The Government has recently[2] introduced a consultation on draft legislation that purports to address income shifting (or income splitting) following the success of the taxpayer in the House of Lords in the case of *Jones v Garnett (HM Inspector of Taxes)* [2007] UKHL 35 [2007] 1 WLR 1123, colloquially referred to as the *Arctic Systems* case.

As many of us would be aware by now, the *Arctic Systems* case explored and considered the distributions made to Geoff and Diana Jones, the husband and wife owners of the shares in Arctic Systems Limited. The effect of the split shareholding was that dividends received by Mrs Jones were not subject to higher rate tax but they would have been so taxed had they been received by Mr Jones.

It was HMRC's contentions that the income should, by rights, have been received by Mr Jones giving rise to an additional overall tax liability.

In order to recover the tax advantage apparently so gained, HMRC invoked the settlements legislation – now found in sections 619 to 648 of the Income Tax (Trading and Other Income) Act 2005. After a number of conflicting decisions below, this approach was finally rejected by the House of Lords in July 2007.

However, their Lordships' decision was not entirely good news for small (family-owned) businesses. In particular, their Lordships' House explained that the settlements legislation deals effectively with most forms of income shifting and,

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prima facie, caught the arrangement entered into by Mr and Mrs Jones. However, it did not address the situation encountered in this particular case because the arrangement consisted of, so it was held, an outright gift of property between spouses. Consequently, the statutory exemption conferred by what is now section 626 of the 2005 Act was held to apply.

Barely 22 hours after the promulgation of their Lordships' decision, a Government Minister announced plans to reverse the decision by statute. In order to give the appearance of consensus, the Government explained that any new rules would be subject to consultation with the private sector. However, reading between the lines, it appears that the only room for negotiation concerns the guidance and the putting into practice of the new rules, rather than the statutory rules themselves.

Repeating the understated impact of their challenge under the settlements legislation, the Government has asserted that the draft legislation seeks only "to undo the tax advantage gained by income shifting arrangements in a minority of small modern businesses". Whilst it might indeed give rise to a tax effect in only a minority of businesses[3], a far larger number of businesses will have to jump through the statutory hoops to consider whether or not the new rules apply to them. Furthermore, such an exercise will have to be repeated on an annual basis.

The Government asserts that fairness of the income tax system is undermined if some individuals are able to dissociate themselves from income that they would have received to enable the income to be taxed in the hands of another individual at a lower rate. The main aim of the proposals is, essentially, to *provide a fair tax system and ensuring that, with clear legislation, such cases can be dealt with effectively and that clarity can be given to businesses and their advisers*.[4]

This article seeks to explore whether the published draft legislation (and extensive guidance) accomplish the Government's set goals of fairness and clarity and analyses how the rules might work in practice.

The draft legislation in a nutshell

The proposed legislation covers just two pages of A4. It is proposed to introduce a new Chapter A1 into Part 13 of ITA 2007 (tax avoidance). The proposed Chapter is composed of six sections.

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3 The proposals are budgeted to raise an average £200m per annum in additional tax. Given that the maximum tax saving that can be achieved is about £7,500, this suggests that between 25,000 and 30,000 couples are expected to pay additional tax under the rules.

4 Income Shifting: a consultation on draft legislation at p 5, para 1.13.

The first four sections (one of which is a short overview) deal with the definition of income-shifting, followed by an explanation of the tax consequences and finally offer an exemption to the general rule.

Stated simply, the rules are intended to catch situations in which:

1. one individual receives more income from an arrangement than he or she would receive if all parties were acting at arm's length;

2. that income is received at the expense of another individual;

3. the income represents dividend income[5] or the profits from a partnership; and

4. this 'redistribution' of income carries an income tax advantage.

Historical context

The latest draft legislation can be seen to represent another stage in the Government's campaign to punish individuals who take advantage of the different tax rates available to different types of legal entity. (For this purpose, we include National Insurance Contributions as a tax.) Chronologically, the first shot in this campaign was the introduction of the so-called IR35 legislation, currently found in the Income Tax (Earnings and Pensions) Act 2003, Part 2, Chapter 8 and, for National Insurance purposes, in the Social Security Contributions (Intermediaries) Regulations 2000 (SI 2000/727).

That legislation was designed solely to prevent individuals who are effectively working as employees from taking advantage of the tax preferential rates given to shareholders in limited companies, whose profits can be extracted by way of dividend, without the imposition of National Insurance.

In the typical case, but by no means the only scenario targeted by the legislation, a worker would interpose a limited company in the contractual chain between him- or herself and the ultimate user of his or her services. Profits from the arrangement would then be accrued by the limited company, which would pay corporation tax thereon, and these 'after tax' profits would then be paid to the 'worker'/shareholder in the form of dividends.[6]

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5 strictly, any form of company distributions

6 Often, a salary equal to the individual's personal allowance would be taken as well so as to take advantage of the tax-free income available to individuals, to notch up the National Insurance credits for the purposes of contributory benefits and to create a tax-deductible expense in the company.

Whilst the implementation of the IR35 rules is open to question, the focus of the rules is clear and this is enshrined in the statute. Would the worker not have been subject to a contract of employment if he or she had been engaged directly by the end user of the arrangement then the rules cannot apply.[7]

The IR35 rules had the result of ensuring that dividends in such cases would not generally escape National Insurance and, therefore, the main concern of the Exchequer was thereby alleviated.[8] However, the IR35 rules also had the effect of tackling those cases where the tax savings were increased by the division of shares in the intermediary company, typically with shares being owned by the worker's spouse and it was sought to take advantage of the rules for independent taxation.

Independent taxation – an overview

The focus of the IR35 rules is therefore the scenario where the worker is effectively an employee (and, in the Government's view, should be taxed as such). The clear message from the Government is therefore that the preferential tax treatment accorded to entrepreneurs, and shareholders more generally, should not abused by those for whom it was not intended.

Yet, behind the scenes, the Government was attacking another situation, which was far more widespread: the use of split shareholdings (typically by husband and wife) for stakes in a family business.

Ever since the introduction of independent taxation, which came into effect on 6 April 1990, it has been possible for family income (which, for simplicity, we will limit to income of a husband and a wife) to be shared, with, in many cases, the consequential advantages of higher rate tax being avoided either in full or at least partially.[9]

There are restrictions to this. For example, if one spouse is employed with a salary of £50,000, say, it is not possible for the couple to elect that each is taxed on £25,000, say, or for some other split to be agreed upon. The £50,000 salary is taxed on the individual who is employed and earning that figure.

7 See, for example, ITEPA 2003, section 49(1)(c).

8 The practical difficulties of enforcing the IR35 rules, however, has more recently led to the introduction of the Managed Service Companies rules, now found in ITEPA 2003, Part 2, Chapter 9.

9 Prior to 6 April 1990, a wife's income was (generally) aggregated with that of her husband and any higher rate liability was considered by reference to the aggregated sum. Therefore, in general, it was of no tax benefit to couples to redistribute their income.

However, where the couple owns income-producing investments, the transfer of such investments can ensure that some income within the family can escape taxation at the higher rates.

Prior to 1990, this approach could have been adopted by unmarried couples as their income was never subject to aggregation[10]. However, care was often needed as the transfer of assets between unmarried persons could give rise to capital gains tax, inheritance tax, Stamp Duty and, latterly, SDLT. Any such transfer could also have given rise to issues relating to the settlements legislation. However, where there was no situation in which the transferor could be said to have retained an interest in the underlying asset, that risk was minimal.

In the context of married couples, most of the capital gains tax, inheritance tax, Stamp Duty and, latterly, SDLT issues are less of a problem.[11] However, given the fact that the settlements legislation explicitly treats husbands and wives (and civil partners) as a single entity, the freedom to transfer assets (as opposed to merely acquiring them in a tax-efficient fashion) would have been significantly curtailed.
It was for this reason that the Government introduced what is now ITTOIA, section 626, the exemption for outright gifts between spouses (and, now, civil partners), the provision that rescued Mr and Mrs Jones in *Arctic Systems*.

Fairness

Under the law as it currently stands, therefore, husbands and wives (and civil partners) are entitled to transfer assets between themselves in a generally tax-efficient fashion. Furthermore, the income tax advantages that flow from the consequential redistribution of income are not, in the main, countered by the settlements legislation.[12]

Is this fair? Well, it probably depends on your perspective. To the extent that an investment portfolio giving rise to an annual income of £70,000 can be shared tax-efficiently by two spouses but a salary of the same amount cannot then it is probably unfair. On the other hand, the pre-1990 rules discriminated against married couples and could equally be described as unfair. At least, since 1990, couples (whether

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10 at least as far as tax is concerned

11 Care needs to be taken, however, in respect of transfers at an undervalue of assets from a UK-domiciled transferor to a non-UK domiciled spouse because of the £55,000 limit in section 18(2) of the Inheritance Act 1984.

12 This, of course, presupposes that the conditions in section 626 are in fact satisfied. In particular, the gift has to be without restrictions and not substantially a gift of income. This latter condition caused the downfall of the taxpayers in the pre-*Arctic* case, *Young v Pearce* (1996) 70 TC 331. In that case, the taxpayers sought to benefit from independent taxation by allowing their wives to subscribe for preference shares in their jointly-owned company.

married or not) can arrange their affairs in similar ways with similar *income* tax consequences[13].

More importantly, as confirmed by the House of Lords in *Arctic Systems*, dividend income from a company running the family business is subject to the same principles.

However, even more important than fairness is the fact that this was explicitly stated to be the consequence of independent taxation. In the 1989 Finance Bill debates, Norman Lamont, then Financial Secretary to the Treasury, had to deal with an Opposition proposal to withdraw what is now section 626.

The Opposition noted that the section would facilitate income sharing within a family and this could lead to reduced tax revenues. In response, Mr Lamont explained that the Opposition's proposal:

- 'would undermine the very basis of independent taxation. If the amendment were carried, there would be no independence for married couples, nor would people be free to arrange their affairs as they wished.

- Independent taxation is bound to mean that some couples will transfer assets between them with the result that their total tax bill will be reduced. ***This is an inevitable and acceptable consequence of taxing husbands and wives separately***.' (emphasis supplied)

Under the current proposals, the Government does not wish to go so far as to remove section 626, as per their original plan whilst in Opposition. In other words, they seem to have accepted that it is perfectly acceptable for income to be shared by couples in some situations, even if that gives rise to tax savings. However, they are unhappy when the tax savings achieved are generated by the redistribution of business profits.[14]

The probable justification for the distinction is that business profits relate to the efforts of an individual or individuals and therefore tax savings should not be available in this context any more than they are in the context of employment income. However, philosophically, it is difficult to differentiate between the income arising from a shareholding in a family company from a passive shareholding in a quoted plc. The Government seems to be favouring the latter over the former.

Is this fair? Probably not.

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13 We ignore, for this purpose, the remnant of the married couple's allowance.

14 See, Condition D in proposed section 681B.

Does it send the right messages to the electorate which sees "hard working families" being penalised whilst those individuals who can afford to live off investment income are able to continue to benefit from the tax advantages (or, strictly, the tax neutrality for married couples) introduced back in 1990? We very much doubt it.

Does it send the right messages to the population about the importance to the economy of entrepreneurial activity?[15] Certainly not.

What is worse, in our view, however, is that the Government seems to have had no regard to the genuine uncertainties that businesses will have to face under the new rules – whether or not the application of the rules will have any tax implications at the end of the day. Such uncertainties will give rise to additional compliance costs (both during the preparation of Self Assessment returns and, one assumes, in the course of any subsequent enquiry). These costs will not be faced by any other sector of the economy.

Furthermore, the tax differentials highlighted by the *Arctic Systems* case are simply the result of the fact that business income is generally taxed differently from other types of income. To tackle one aspect of that in isolation and to do so in the name of fairness is disingenuous or, simply, unfair.

Clarity

Proposed section 681A – overview of the Chapter

As with the rest of Part 13, the Chapter opens with a section containing an overview of the Chapter. Proposed section 681A states that the Chapter makes provision for countering income tax advantages obtained by income-shifting. Given the fact that the section consists of thirteen words (or twelve if the hyphenated expression 'income-shifting' counts as one), it is hard to criticise the section for lack of clarity. Indeed, it should be welcomed as it states explicitly that it is only *income tax* advantages that are being targeted.

Proposed section 681B(1), (2) – income shifting

Section 681B(1) refers to situations where income has been "shifted" from one individual ("Individual 1") to another ("Individual 2"). There are no types of relationships specified and, in contrast with the settlement legislation, there is no mention of spouses or civil partners in any of the sections. This is somewhat surprising since this draft legislation was plainly introduced as a reaction to the

15 The Government's sycophantic comments in the Pre Budget Report suggest, at best, an extreme example of irony. That statement opened: "The Government recognises the contribution that small businesses make to the economy and that business owners should profit from the success of their business. However …" (Press Notice 2, 9 October 2007).

judgment in the House of Lords which it was specifically designed to reverse. However, at least it cannot be criticised as a further assault on the institution of marriage (or civil partnerships).

The purpose of the draft legislation is indeed said to be to deal with situations like the Jones family (in Arctic Systems Ltd) in which a couple are the main shareholders of a small company and where both parties are in receipt of a modest salary and surplus profits by way of dividends, irrespective of the value of the work undertaken by each individual.

We know from the statement released by the Government 22 hours after the House of Lords' decision, that the draft legislation is aimed at preventing small businesses or family businesses from gaining an 'unfair' tax advantage by way of income shifting. Unfortunately, this is not clear from the terms and provisions used in the draft legislation, not the least because there is no limitation or indication of the size of any given business which means it includes a very wide ambit of businesses.
Superficially, the legislation does not seem to catch arrangements involving the 'shift' of income to limited companies or trusts, as these are not individuals. However, care needs to be taken as the ultimate beneficiaries of such arrangements could be individuals. And when such individuals receive their income under the arrangement, the legislation can once again be invoked. Thus, the legislation could strike at cases where individuals enter into a partnership with a limited company which is not wholly owned by that individual. Because of the time lag between the income first being generated and Individual 2 getting his or her hands on the income, a number of practical difficulties could arise in practice as will be considered further below.

Section 681B(2)–(6) sets out a number of conditions (A to D) that must be met in order for income shifting to be deemed to have taken place which are now discussed below.

Proposed section 681B(6) – Condition D – partnership share or dividends

The final condition for income shifting, but the first to be considered here, is Condition D which requires the shifted income to consist of:

(a) *distributions of a company, or*

(b) *profits of a partnership.*

Thus, the Government has limited its attack to only certain types of income. Most importantly, the proposed new rules cannot bite if Individual 2 receives an overly generous salary. Presumably this is because the Treasury would be happy to receive correspondingly excessive National Insurance contributions and, where the salary is really excessive, HMRC can always disallow some of the payment in the employer's income or corporation tax computations.

Proposed section 681B(3) – Condition A

Proposed section 681B(3) provides as follows:

> *Condition A is that Individual 1–*
>
> *(a) is a party to relevant arrangements, or*
>
> *(b) has the power to control or influence relevant arrangements.*

Condition A applies therefore in one of two circumstances. Either Individual 1 must be a party to relevant arrangements (which, assuming one can identify what are the relevant arrangements, should be relatively straightforward) or that individual must have the power to control or influence such relevant arrangements. Because this latter test is used elsewhere in the Chapter and will be considered in more detail below, it is not considered further here.

The definition of "relevant arrangements" can be found in section 681E, this section is far from straightforward or user-friendly; it is composed of no fewer than six subsections, amounting to about 40% of the overall length of the proposed Chapter and which attempt to define a number of concepts to be used in previous sections but which fail to define precisely abstract concepts or to take into account how a trade or business may operate in practice.

Proposed section 681E – Meaning of 'relevant arrangements'

Section 681E provides:

> *(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 would have been made between persons not connected with each other dealing at arm's length, or

(b) such as would have been entered into between such persons so dealing.

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

A number of uncertainties arise from the above subsections. First, subsection (1)(b) sets out an objective test for relevant arrangements that presumably would have to be carried out by the taxpayers, an officer of HMRC upon a detailed enquiry into the Self Assessment and, ultimately, by the Courts.

Whilst the test is objective – in that the legislation looks at what would be a reasonable conclusion to draw – it is also inherently subjective – in that it requires investigation of "all the circumstances of the case".

In other words, if a genuine non-tax reason can be put forward as the real reason underlying the arrangements then the legislation cannot be applied.

For example, let us consider the facts of the *Arctic Systems* case. Mr Jones thought about going freelance when he was made redundant in 1992. Rather than make such a decision unilaterally, however, he discussed the pros and cons with his wife.

Mr and Mrs Jones stated that they shared everything in the course of their marriage and they saw no reason to do otherwise with respect to the shares in their business.[16] Is this sufficient to justify the equal shareholding? On its own, probably not. The draft legislation looks at whether the tax benefits could represent ***one of the main purposes*** of the arrangements. On the facts of the *Arctic Systems* case as found by the Special Commissioners, Mr and Mrs Jones were advised by their accounts that “it was normal for husbands and wives to own the shares in this way”. Furthermore, Mr and Mrs Jones understood that it [also] had tax advantages.

It would be rare for accountants to recommend a structure that is distinctly tax-inefficient when a better alternative exists. Thus, in all cases where taxpayers are professionally advised (or ought themselves to be aware of the tax position), the chances are that the arrangements entered into will be tax-advantageous. Prima facie, therefore, arrangements entered into by anyone with tax knowledge (actual or imputed) could be thought to be caught by the legislation.

However, the legislation can be read so as to narrow the scope of the provisions. The ‘objective-subjective’ test requires one to consider the purposes of the arrangements and whether or not they involve the intended “avoidance or reduction of a charge to income tax”. Both limbs to the test assume two states: the ‘norm’ and the actual. The ‘norm’ represents the amount of tax that *ought* to be paid and the actual represents the tax liability as a result of the arrangements entered into.

Unfortunately for the sake of clarity (but not necessarily so for the sake of taxpayers targeted by these rules), there is no statutory definition of the ‘norm’. How, therefore, can one ascertain what is meant by the avoidance or reduction of such tax? Furthermore, it should be noted that this draft legislation, although not explicitly stated, is aimed at small, family-owned businesses.

More so than in other contexts, there will be a disproportionate number of non-commercial factors that will affect how the business is conducted and owned. It is suggested that it can be only after these are taken into account and factored as the ‘norm’ that one can then consider whether the arrangements are designed to give rise to a further tax benefit.

For example, a generous share allocation to one’s spouse might prove to be the price to pay for marital harmony if one spouse wishes to abandon the relative safety of employment and try his or her luck with a commercially riskier venture. Such a venture might involve longer working hours, more time away from home or some other impact on the family’s lifestyle. Whilst many spouses might be expected to be supportive of their other half’s ambitions, it is not unreasonable for them to want a slice of the action. Nor is it, in our opinion, unreasonable for them to receive it. If

16 It will be recalled that the clients of any IT business required their ‘freelancers’ to operate through the medium of a limited company.

that is the case, then perhaps the main reason for the arrangement can be said to be other than fiscal in nature.

It is also instructive to consider the words of the late Lord Nolan in *Willoughby v IR Commissioners* in respect of the meaning of 'tax avoidance' in the context of the provisions that now form Chapter 2 of the Part into which these proposed new rules will be inserted.

> 'The hallmark of tax avoidance is that the taxpayer reduces his liability to tax without incurring the economic consequences that Parliament intended to be suffered by any taxpayer qualifying for such reduction in his tax liability. The hallmark of tax mitigation, on the other hand, is that the taxpayer takes advantage of a fiscally attractive option afforded to him by the tax legislation, and genuinely suffers the economic consequences that Parliament intended to be suffered by those taking advantage of the option.'[17]

In other words, taking advantage of a fiscally attractive arrangement does not by itself constitute tax avoidance. It is submitted therefore that, equally, it cannot give rise to a 'reduction of a charge to income tax'.

Leaving aside these arguments, it is particularly concerning also that the wording of the guidance published alongside the draft legislation does not seem to have been aligned with the proposed clauses.

For example, proposed section 681E(1)(b), which contains the objective-subjective test, asks whether or not "the avoidance or reduction of a charge to income tax" could be seen as a main purpose of the arrangements. The draft guidance, on the other hand, gives a different account. At paragraph B.22, readers are told:

> 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. …

That is plainly untrue. As has already been discussed, the definition of "relevant arrangements" requires the main purpose or one of the main purposes to be the avoidance or reduction of a charge to income tax.

17 Lord Nolan's speech actually attributes this distinction to the submission made by leading Counsel on behalf of the Crown, Launcelot Henderson QC. He is now Sir Launcelot and one of Her Majesty's Judges in the Chancery Division of the High Court.

Consequently, when the guidance continues:

> "Tax advantage" is not defined …

one can simply respond by noting that no such definition is needed. Although the term "tax advantage" does appear in the draft legislation, it does not do so in any operative form.

On this basis, one perhaps ought to draw a veil over the rest of paragraph B.22 as it could just be a result of the draft guidance not catching up with the draft legislation (or, perhaps, the draft legislation not catching up with the draft guidance). However, the rest of paragraph B.22 in fact reveals the profound lack of understanding of the subject which is often too apparent in new Government initiatives in the field of tax law. Having noted that "tax advantage" is not defined in the draft legislation, the paragraph continues:

> … 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.

Does the Treasury official responsible for this sincerely believe that, assuming the term 'tax advantage' were contained in the legislation, it would be interpreted by the Courts in the way suggested? If so, could the same Treasury official explain why it would then be necessary to define the term 'tax advantage' in the other places where the term is actually found in the legislation (for example, in ITA 2007, section 683, the second section after the Chapter intended to be inserted)?

So far, we have considered only the second of the two-part test in the definition of "relevant arrangements". The first part requires the arrangements also to be other than "genuine commercial arrangements". If that test were left unqualified, the draft legislation's intended aim of clarity would be blown out of the water because this was one of the issues with which the House of Lords and the Court of Appeal disagreed in *Arctic Systems*.[18]

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18 In the Court of Appeal, the Court held unanimously that the settlements provisions did not apply partly because the set up of the company represented "a normal commercial transaction between two adults, to which each is making a substantial commercial contribution, albeit not of the same economic value".

Lord Hoffmann, however, disagreed. At least in part. As he said:

> "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."

In other words, the commerciality of the arrangement or the normality of it depends on one's perspective.

For the sake of clarity, therefore, one should welcome the fact that the term "genuine commercial arrangements" is exclusively defined by three conditions that must all be met.

Condition A is that the arrangements must be effected in the course of a trade or business or with a view to setting up a trade or business. No great uncertainties there, except where one considers that a legitimate reason for setting up a business or trade between spouses or close family members is often to share equally any profits or liabilities that may be incurred by the company in the future. As has already been stated, few people would willingly set up a business in way that is not tax efficient and it is not unreasonable to expect people in a close personal relationship to arrange their affairs in a way that is different from the way unrelated people would carry on business.

Furthermore, many taxpayers might have been foolhardy to follow the advice put out by the former Department of Trade and Industry. For example, they recommended husbands and wives to take advantage of the tax-efficiencies of joint ownership of the family business until it was pointed out to them that such a strategy was being targeted by the then Inland Revenue as some form of unacceptable tax planning. The proposed new rules are designed to have effect with respect to income received after 5 April 2008, even if the business was set up long before this date. It will be a sad irony if individuals are caught by legislation introduced in 2008 (in the name of fairness) when they did no more than what was recommended to them in earlier years by the Government department that is meant to promote business.

Condition B applies only if the business consists of making and/or managing investments. When it does apply, the persons by whom and for whom the investing is done must not be connected with each other and must be dealing at arm's length.
Condition C applies in all cases. It requires that the arrangements are not on terms other than those that would have been made between persons not connected with each other at arm's length. The ambit of this condition is, in our submission, too wide; it fails to take into account real business situations where the parties have known each other for some time, where there have been previous dealings, where trust has been built and where unusual transactions are entered into. Given the Government's acknowledgement that family members are often a bonus to family businesses, given that they will often be prepared to accept non-commercial terms of engagement, Condition C provides the metaphorical slap in the face for such entrepreneurs.

However, following the Falstaffian approach – favouring discretion over valour – the draft guidance makes no comment on how Condition C might be interpreted in practice.

Proposed section 681B(4) – Condition B – forgoing income

Section 681B (4) sets out the second condition that must be fulfilled in order for income to have been shifted from one individual to another:

> *(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").*

Therefore, the Chapter applies only if both Individual 1 forgoes income and that income would (but for the provisions) be the income of Individual 2 in the relevant tax year.[19] It is clear, however, that Individual 1 could have forgone the income in another tax year. In many cases, it is the deferral rather than the avoidance of any tax charge that is sought by the taxpayers concerned. In such cases, the proposed new Chapter will not necessarily prove to be any obstacle.

For example, suppose X and Y are civil partners and X carries on a business through the medium of a company in which X is the sole shareholder. X is keen to reduce the overall tax burden of the household and, in the wake of the decision in *Arctic Systems*, gives Y some shares in the company.

Suppose that the end result is that Y receives income in the 2008/09 tax year that X would otherwise have received in 2007/08. Subject to the full conditions of proposed Chapter A1 applying, X is deemed to have received the income in 2008/09.

Thus, to the extent that the "relevant arrangements" give rise to the deferral of a tax charge, the legislation is of little effect. This could be of use to taxpayers when an anticipated loss is to be generated and a deferral is necessary to allow the loss to be used or it is known that future marginal tax rates will be lower.

The expression "forgoes income" is defined in section 681F thus:

> *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 income but does not receive it, or*

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19 As will be seen later, it is in that "relevant year" when the Chapter deems the income to be that of Individual 1 (rather than Individual 2) (proposed section 681C).

(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.

The two limbs of the definition appear to be a late recognition of one of the complaints about the Government's rhetoric in *Arctic Systems*. Frequently, it was alleged that Mr Jones had permitted his wife to receive *his* income when in fact Mrs Jones was merely entitled to a share of *the company's* income.[20] Thus, the definition of forgoing income attempts to cover cases not only where Individual 1 ***would be*** entitled to the income but also those cases where Individual 1 "***might reasonably be expected*** to receive" the income.

Thus, the first part of the definition might cover cases where Individual 1 is a sole trader and would generally be entitled to the income arising. The second part of the definition, on the other hand, will cover cases where a company is used and the individuals share the ownership of the company. In such cases, no individual will be entitled to any income arising. However, can it be said that "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"?

According to the draft guidance (paragraph B.31) one might look only at the work undertaken and the generation of the profits. However, the legislation adds a further test not referred to in the guidance[21]. It requires one to consider also "all other relevant circumstances".

Perhaps this test actually shows how limited in scope the proposed rules will be.
As has already been suggested, the decision to go freelance will often be a joint decision by a couple, even if only one partner is actively involved in the business. Would it be reasonable to expect Individual 1 to receive all the profits of the business when the opportunity to enter the business is due to the unstinting support of Individual 2? We think not.

Furthermore, as the Government itself acknowledges, family members might often be prepared to take a cut in wages (and could even, in certain circumstances, be lawfully paid at below the National Minimum Wage).

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20 If the Government cannot recognise that shareholders and directors do not have any rights to assets belonging to a company (after all, it is only 110 years since the House of Lords gave its decision in *Salomon v Salomon & Co* [1897] AC 22), perhaps they will now be more forgiving when errors occur in small companies.

21 although the guidance does recognise that the facts of each case will often be more complex than those in the published examples (paragraph B.32)

For example, in the Business Link service now operated by HMRC, it is noted that:

> “family members may be more willing to make financial sacrifices for the sake of the business. For example, accepting lower pay than they would get elsewhere to help the business in the longer term, or deferring wages during a cashflow crisis.”

In other words, HMRC accept that family members are prepared to make sacrifices for the sake of a family business. It cannot require too much of a leap of imagination for HMRC to recognise that such family members ought to be rewarded handsomely when the business can afford it. It would certainly be ungracious (and unreasonable) for Individual 1 in those circumstances to expect to receive all income subsequently arising to the family member.

Does this apply in every year or just in the early years? Naturally, it would be necessary to consider all the facts of the case but in many situations where a beneficial profit share in early years is thought appropriate, it would seem reasonable for the profit share to continue in future years.

This can be best illustrated by considering a commercial relationship which is clearly at arm’s length: the provision of financial support by a venture capitalist. In such cases, person A will be carrying on the work and generating the profits. However, the venture would not be possible but for the support of person B, say. Clearly, whilst the financial support is a commercial necessity, person B should be entitled to a share of the profits. However, does this mean that person B should be excluded from future shares as soon as the business is financially more secure? Most venture capitalists, we suspect, would expect to continue receiving a generous share of the profits until such time that they are able to realise their capital share – to reflect the risks that they took in supporting the venture in the first place. For the same reason, it is suggested, the receipt of a ‘generous’ profit share by family members would not necessarily trigger the ‘forgone income’ test.

The guidance notes consider cases where Individual 2 might put forward financial support and, like a venture capitalist, will not be caught by the proposed rules if income continues to flow to him or her. However, limiting the scope of the exception to such financial support is, we believe, simplistic. For many family businesses, it is not the provision of financial support that is crucial in the early months or years but the moral backing. There seems to be no reason why such support should not be treated as favourably as financial help when assessing whether or not income has been forgone.

However, the fallacy in the drafting of proposed section 681F goes deeper than this. In the idealized world populated only by Treasury officials, a business venture operated by an individual through the medium of a company would, on an annual basis, distribute all profits so that the individual can make his or her full contribution to the economy by maximizing his or her assessable income.[22] However, in the real world, taxpayers tend to leave funds in a company until such time as they require them or until they can be extracted by way of capital distribution or as a contribution to a pension fund. Therefore, just because Individual 2 receives more money from the business than might otherwise be expected, it does not mean that that income might reasonably be expected to have been received by Individual 1. The proposed statutory test is not whether Individual 2 has received any 'bounty' but whether or not Individual 1 ought otherwise have received that income.

Thus, it is our view that in the vast majority of situations, a solid defence to the rules can be mounted.

Proposed section 681B(5) – Condition C – power to control or influence

> *Condition C is that Individual 1 has the power to control or influence the amount of the shifted income.*

As has already been stated, the proposed legislation might bite if Individual 1 is not a party to the arrangements but has the power to control or influence them (part of *Condition A*). In either case, however, the legislation can bite only if Individual 1 "has the power to control or influence the amount of the shifted income".

In the draft guidance, the Treasury does not comment on the application of the test in Condition A – saying that it is factual and depends on the circumstances in each case[23].

In respect of Condition C, the draft guidance provides, however, (under the heading of Example B) two discrete examples of how this test might work.

In the first, it cites the example of Individual 1 who owns a small shareholding in a major plc. In the example, Individual 1 transfers a quarter of this shareholding to her husband. Neither spouse works for the company.

Since neither shareholder is apparently able to affect the timing or level of dividends declared by the company, the guidance suggests that the Condition is not fulfilled in

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22 Of course, in this bureaucrat's Utopia, one is presumably required to obliterate any memory of the non-corporate distribution rate which was intended to penalize the extraction of dividends from such companies on the basis that it was better to reinvest profits for future growth.

23 para B.15. With respect, it is submitted that the application of each test depends on the facts and circumstances of the particular case.

the case.[24] It is not clear whether HMRC would regard the situation any differently if Individual 1 were an employee of the company. Surely, only the most senior of management could be described as having the power to control or influence the timing of dividends.

On the other hand, if the company is democratically run with all workers being consulted on such matters (an ideal that surely the Government would wish not to discourage) is there a risk that members of workers' committees could fall foul of the test "power to control or influence"? Arguably, the answer is no because their ability to contribute to corporate decisions is simply a result of the fact that the directors have shown a willingness to listen to representations but, ultimately, the power (as with the corresponding responsibility) rests with the Board in accordance with company law.

If the wife in the example, however, were a senior member of the executive board, she would clearly have the power to control or influence the amount of company dividends. Does this mean that most employees of plcs need not worry about these rules but they can nevertheless affect directors? Arguably, no one director on a large board can have the power to control the payment of dividends but all directors would be abrogating their responsibilities if they did not at least attempt to influence such payments. However, perhaps, the legislation should be interpreted in such a way that the director must have more than the right and duty to influence dividend payments i.e. so that the director has also the legal power to have an actual effect on them.[25]

If not, the legislation could unwittingly catch the thousands of cases where a director has previously transferred shares to his or her spouse in order to avoid or reduce the higher rate tax payable on company dividends. Furthermore, couples would be caught even when such transfers occurred many years before the employee was elevated to the boardroom.

Whatever is the correct interpretation, employees and directors of large companies will not need to worry if the shares are initially acquired by the non-employee and then transferred to the employee. This is because the draft legislation requires Individual 1, the person to have forgone the income, to be the person with the power

24 The draft statutory test requires Individual 1 to have control or influence over only the amount of the shifted income. Therefore, it is not entirely clear why the guidance refers also to the timing,

25 The draft guidance suggests that the phrase "power to control or influence" is not defined and is intended to be interpreted in the widest sense (para B.34). It is not clear whether this statement is intended to satisfy the *Pepper v Hart* test and be available to the Courts which will one day have to consider the meaning of the test. Perhaps it is there just to scare taxpayers and their advisers. If the Government wants a phrase to have a particular meaning, it would be a good idea (as well as clear and fair) if the meaning were actually included in the statute.

over the company's affairs. Therefore, in the case of larger companies, it would seem possible for most taxpayers, if properly advised, to circumvent the proposed new rules. But this will not assist cases where shares have already been transferred by the employee to the non-employee. Nor does it explain why small businesses are being unduly penalised so as to subsidise their larger competitors. Not only are the proposals unclear but they seem to lack fairness as well.

The second scenario in Example B concerns the transfer by the sole shareholder of a company of one quarter of the shares. In such a case, it is difficult to argue that the transferor continues to have power to control or influence the dividends.[26]

In *Arctic Systems*, Mrs Jones owned one half of the shares and therefore had considerable rights over the company's affairs. However, as sole director (and with the casting vote given to him in accordance with the company's articles of association), Mr Jones probably retained the power to control or influence the amount of dividends paid by the company.

However, it is not necessarily the case if Mrs Jones became a second director – especially if she also took over the chair of the company. In such a case, would it be right to say that Mr Jones still had the power to control or influence the dividend payments? Possibly not.

The answer seems even clearer if Mrs Jones were to acquire another 25% of the shares of the company. In that situation, Mr Jones would be no more than a significant minority shareholder of the company. It would be more difficult for HMRC to show that he has retained any power over the company's dividend policy. In fact, the draft guidance recognises the difficulties that HMRC will have in dealing with such cases.

> 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.

26 Again the guidance refers to the timing and the amount of the dividends. However, we shall ignore references to the timing as it is outwith the proposed statutory test.

In our view, these examples represent pure fantasy (or at least, optimistic bluffing) on the part of HM Government. If someone does not have the power to control or influence the payment of dividends HMRC cannot impute such power when it suits them. It is accepted that Mr Jones, to revert to the *Arctic Systems* scenario, could always prevent income from being earned by the company (and therefore influence the availability of profits for distribution to shareholders) by refusing to work for the company at the modest salary awarded to him. But, there again, so could his wife. If the phrase “power to control or influence the amount of the … income” extends to the use of industrial blackmail then baggage handlers at the UK’s airports would have power to control or influence the availability of dividends payable to shareholders of the airlines relying on their services. We suggest that this is too wide a reading of the words.

Proposed section 681C – the consequences

Section 681C provides what happens in situations where the various conditions are all satisfied.

In the tax year in which Individual 2 receives the income, the income is treated as that of Individual 1 instead. The guidance suggests, probably correctly, that the nature of the income is not affected by the switch.

The legislation provides no mechanism for Individual 1 to obtain from Individual 2 either the income attributed to Individual 1 or even the tax payable thereon.

Proposed section 681D – the exemption

However, proposed section 681D provides that the rules are of no consequence if the switching of the income tax liability under section 681C does not increase the overall income tax liabilities of Individual 1 and Individual 2 for the tax year in question.

This is a test that will need to be applied on a year-by-year basis. It is easy to imagine, therefore, situations in which couples have ‘shifted income’ as understood by the new rules by one spouse transferring shares to the other. This transfer could have taken place long before 2008[27]. It is also possible that, if both spouses were higher rate taxpayers in 2008/09 and in later years, neither considered that the rules were ever of any relevance to them. However, if in any year, the ‘transferee’ spouse starts paying income tax at a lower marginal rate than the ‘transferor’, the proposed rules will kick in. Couples will therefore need each year to consider all dividend or partnership income that they receive and whether or not it arose under relevant arrangements.

27 but presumably since the Budget 1988 announcement regarding the advent of independent taxation

On the other hand, it is only income tax that is considered by the rules. Thus, savings can still be achieved in the context of National Insurance contributions. For example, suppose that P runs a sole trader business with annual profits of £20,000 and P brings in Q, P's spouse, as a 50-50 partner. Modest National Insurance (if not income tax) savings might be achievable in such circumstances. Further such savings could be made if Q is merely a sleeping partner[28] or above the 'pensionable age' for such contributions[29].

The consultation document suggests that it is intended that the Class 4 National Insurance treatment will follow the income tax treatment. This is indeed the likely consequence of section 15 of the Social Security Contributions and Benefits Act 1992 and so any partnership income reattributed to Individual 1 will attract a corresponding Class 4 liability. However, the proposed rules will not prevent National Insurance savings from being achieved when there is no income tax benefit being achieved by the arrangements. Furthermore, National Insurance savings are not considered by proposed section 681D and so any National Insurance planning will escape with impunity.

Similarly, the exemption considers only the income tax liabilities of the two individuals in the year in which Individual 2 receives the income. Thus, as has been suggested elsewhere, the rules do not prevent the deferral of income, even if this leads also to an overall reduction of the tax payable.

Applying the exemption

What is possibly the most objectionable aspect of the proposed new rules is that they drive a coach and horses through the concept of independent taxation and taxpayer confidentiality more generally. One of the political drivers towards independent taxation was to need to allow spouses to be taxed on their income separately without the legal requirement for one, the wife, to disclose income of her income to the other, her husband.

If the new rules are enacted, information sharing will once again be needed. In fact, under the proposed new rules, the sharing of information goes wider: not only will wives have to disclose their income details to their husbands (as was the case before 1990) but husbands will now be required to give their income details to their wives. In fact, it is not only spouses and civil partners who will have to share tax details with each other but in fact any two individuals, if they think that they are within the

28 and therefore not liable for Class 4 contributions

29 and therefore exempt from liability for Class 4 contributions (SI 2001/1004, reg. 91)

rules, will have to disclose to each other the contents of their tax returns[30].

The draft guidance reminds individuals that they are each responsible for completing their own tax return. That is indeed uncontroversial. However, the guidance continues to suggest that each individual is responsible for providing information to the other parties involved in any income shifting. It is not clear what the authority is for that assertion.

Nor is it clear what the consequences are for individuals who fail to advise their spouses, lovers, business partners etc every detail of their income for these purposes. Even if one individual is trying to comply with the rules, it is not going to be the case that the other individual will agree that income has been shifted.[31] Consequently, the first taxpayer will be unable to complete his or her tax return in full confidence that it is correct.

The professional bodies of advisers engaged to prepare clients' tax returns will need to address the very real problems that will arise in practice. In many cases, the same adviser will prepare both parties' tax returns. However, client confidentiality will usually require the adviser to keep return information separate from the two individuals – even when parties have no secrets from each other. Without any legal obligation requiring advisers or taxpayers to divulge such information, advisers could be in breach of their professional duties if they prepare tax returns as required under the proposed rules.

For example, it is easy to imagine situations in which one spouse might want the other to think that their income is higher than it really is. Alternatively, there will be situations in which spouses want to keep under wraps a particular source of income. In both situations, the truth will be known by the adviser but the adviser will be under a duty to be discreet.

The practical difficulties will mount (or will at least be more obvious) in cases where the two individuals' tax returns are prepared by different individuals, perhaps at different firms.

In all such cases, it will seem that the appropriate response will be, assuming that it is accepted that income shifting has occurred, for a clear note to be included on the

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30 It is not just details of the *amount* of income that will have to be exchanged, but because one will need to take into account the total tax liability, the details of the *nature* of any such income will also need to be provided and whether or not there are any losses available. If it were not for the flat-rate 18% capital gains tax rate proposed to apply to all taxpayers (regardless of their income levels) from 2008/09, details of capital gains would also need to be exchanged.

31 Although this might lead to an increased income tax liability in the year, the second individual might have commercial reasons for suggesting that he or she has received a fair share of the business's profits.

tax return that the rules are thought to apply but no adjustment has been made because it is not known whether or not the section 681D exemption applies. It will therefore be for HMRC to intervene through the normal enquiry process as suggested in paragraph B.62 of the draft guidance.

However, the timing of the announcement of the proposed new rules is rather ironic. The last six weeks of 2007 involved Government Ministers and Departments reasserting their commitment to the security of personal data.[32]

With the protection of personal data of paramount importance, it is difficult to see how HMRC will be able to enforce the proposed rules. This is because any adjustment to Individual 1's tax return will implicitly involve HMRC telling Individual 1 that Individual 2's income is less than Individual 1's. Equally, assuming HMRC honour their promises to ensure that a consistent approach is adopted for both individuals[33], they will need to tell Individual 2 that Individual 1's income is higher. It is difficult to see how this can be done whilst maintaining the confidentiality of individual taxpayers.[34]

These practical difficulties are multiplied when the income forgone by Individual 1 is 'shifted' to a trust or company and, many years later, is received by a shareholder or beneficiary, who will become Individual 2. Individual 1 might no longer be alive. And even if he or she is, it might be even harder than normal for Individual 2's advisers to make contact with Individual 1 to ascertain whether or not the legislation should be applied. From Individual 1's perspective, he or she might not know whether income has been paid to the beneficiaries or shareholders of the trust or company to which income has been shifted. Consequently, enquiries will need to be made to a potentially vast number of individuals on an annual basis. And, given the duty of confidentiality, there is no guarantee of any response being received.

Other practical issues

The above analysis has focused mainly on the impracticalities of the statutory tests proposed under the new rules. However, for many taxpayers and their advisers, the real issue will be quantifying whether and, if so, how much income has been diverted from one individual to the other.

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32 Yet, at the same time, these proposals apparently expect taxpayers to exchange willingly such information.

33 para B.62

34 We also have the concern that it will be impossible for HMRC to reduce Individual 2's assessable income outside the scope of an enquiry and there is a limited period in which such an enquiry can be opened. (Error and mistake claims cannot be made by HMRC on behalf of taxpayers.)

One of the suggested requirements for the legislation to apply is for an individual not to have received a market salary that reflects his or her obligations and duties within the business. Knowing that the draft legislation is aimed a family owned businesses, using the concept "market salary" is rather nonsensical and artificial as more often than not the duties of one of the shareholders or partners cannot be quantified or given a specific value according to normal market rates. There are no comparables for the same type of duties or hours of work and for the type of out-of-hours commitment that some of these small business owners have to offer.

Indeed, if the market rate is governed by what is done in practice by small family companies, then the market salary might indeed give the same result as the tax-efficient method of limiting salary to the National Insurance threshold.

Furthermore, if partners or shareholders in a business or trade structure hold equal shares of the business and Individual 2 plays a relatively small but invaluable role for the business; how can one determine the market income or salary of such a role? How is one supposed to know whether Individual 2 has taken merely the equivalent of a market salary from the company and if not, does it mean that there has been income forgone by Individual 1?

The guidance provides rather controversially for the case of maternity or paternity leave, although it discreetly, does not refer to it as such.

In Example 10 (at para. B.96–B.98), the guidance discusses a two-person partnership where both partners make an equal contribution to the partnership's business. Consequently, both take an equal share of the partnership's profits. However, Individual 2 stops working after several years (perhaps to bring up a family) yet continues to be allocated a 50% profit share.

Whilst some might consider a generous parental package as enlightened, and in accordance with the current Government's extension of the benefits of maternity leave, such a policy will, according to the guidance, fall foul of the proposed new rules.

However, this example demonstrates the danger of relying on the guidance and not referring back to the underlying legislation. Referring to the conditions in proposed section 681B, it is accepted that Conditions C and D are satisfied.

However, can it be so clearly stated that Conditions A and B are satisfied?

In particular, depending on the circumstances, there is no reason to imagine that business partners would not be willing to continue sharing business profits, considering the commercial need to keep both partners happy the fact that Individual 2 is still liable for the partnership's debts and the fact that Individual 2 might have contributed to the goodwill of the business. Thus, the apparent tax advantages of the arrangement might not be of any relevance to the parties.

Furthermore, the business partners might actually be unconnected persons so that Condition C in section 681E is clearly not satisfied. Thus, the arrangements might well be genuine commercial arrangements and therefore there will be no relevant arrangements as required by Condition A (in section 681B).

Example 10 is also similar to Example 15 (at para B.111 to B.113). The only differences there are that the business is conducted via a company and that, when working alone, Individual 1 is paid a market rate salary, leaving the remainder of any profits to be shared by the two shareholders, as, according to the guidance, "a return on their investment". Perhaps one should be grateful for the implicit concession by HMRC that "market rate salary" is some amount below the actual profits generated by the sole worker. However, it also highlights the myth in assuming that such a figure exists.

Conclusion

The Government has been criticised for seeking to reverse the *Arctic Systems* decision when it should simply accept the result. Its dogged determination to persecute taxpayers further, particularly those carrying on a family business, has given rise to a set of rules that are unfair, unclear and unworkable.

We expect the consultation process to result in a number of representations making similar comments. We hope that this will mean that the legislation will not be enacted regardless. However, we expect to be disappointed.