PKF

Accountants & business advisers

Income Shifting: a consultation on draft legislation
Response by PKF (UK) LLP

We appreciate the opportunity to comment on the above named consultation document issued by HM Revenue & Customs and HM Treasury in December 2007.

In formulating our views on the draft legislation and guidance we have acknowledged that the Government must tackle abusive avoidance activity in order to protect its revenue base. However, we are keen to ensure that family-run businesses carrying on genuine commercial arrangements are not disadvantaged through the imposition of an additional taxation and/or administrative burden.

Our principal comments are as follows:

- We agree that the draft legislation would negate the tax avoidance arrangements that the Government seeks to address. However, we consider that, as currently worded, it would also apply to situations other than the Government's intended targets, particularly investment partnership income.

- We consider that some words and phrases used in the draft legislation are not defined sufficiently clearly enough to allow taxpayers and their agents to apply the legislation with a sufficient degree of certainty.

- We are concerned that unadvised taxpayers will not be given sufficient guidance in quantifying any adjustments required to their self-assessment tax returns.

- We consider that the additional administrative burden faced by small businesses arising from the introduction of the new legislation has been grossly under-estimated in the Government's Consultation Stage Impact Assessment.

In line with the principal comments set out above we urge the Government to either:

- amend the draft legislation to focus solely on trading or professional business income where one of the business owners plays no role or only a minimal role in the business; and

- provide a clearance facility so that taxpayers may obtain certainty over the effect of the legislation on their business arrangements; and

- set out in the legislation precisely what evidence is acceptable to prove, on enquiry, that income-shifting has not occurred.

- we suggest that without an advanced clearance procedure the system will be inherently unworkable.

Our responses to the questions raised by the consultation document are given in the following pages. In the event of any queries on these comments, please contact:

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The consultation

The Government is seeking views on the following issues:

1. To what extent would the draft legislation capture situations in which income arising from a company or partnership distribution has been shifted from one individual to another, for the purposes of gaining a tax advantage?

2. Would the legislation capture situations that are not within the aim of removing the tax advantage gained by income shifting? If so, the Government would welcome examples, an explanation of why you believe these situations are not within the aim of the legislation and, if possible, any suggestions on how these situations may be effectively excluded from the legislation.

3. In what ways could the legislation and guidance provide greater clarity for businesses and their advisers, enabling them to understand when income has been shifted and what to do in these circumstances?

4. Can you suggest any practical steps that the Government could take to ensure that the administrative burdens of the proposed approach are minimised, while ensuring that its aims are achieved?

5. In situations where income shifting has occurred, are you aware of any practical problems that business owners may have in making their self-assessment returns correctly? If so, in what ways can the Government mitigate these problems?

6. Do you believe that the consultation stage impact assessment in Annex C accurately represents the likely impacts on business and the costs that they would incur? If not, what do you believe are the likely impacts and costs and for what reasons?

Answers to specific questions

Question 1 - to what extent would the draft legislation capture situations in which income arising from a company or partnership distribution has been shifted from one individual to another, for the purposes of gaining a tax advantage?

The concept of "income shifting" is described in paragraphs 1.4 - 1.9 of the consultation document. Broadly speaking, this arises where the split of taxable income between the two owners of a business does not correspond to the contribution that those individuals have made to the business.

Paragraph 1.7 sets out the main target of the income shifting legislation. This is where arrangements have taken place such that one of the individuals "plays either no role or only a minimal role in the business, with the [other] individual solely or mainly responsible for the activity of the business and for the generation of the income that is then distributed".

The draft legislation produced in Annex A to the consultation document employs wide meanings and definitions. Broadly speaking, the legislation deals with arrangements entered into by an individual, to allow all, or part, of the income to which he/she is entitled from a business, to be diverted (or shifted) to another individual, in order to derive a tax advantage.

We agree that, as currently drafted, the legislation would broadly be effective in negating the tax advantage arising from most arrangements involving the shifting of income to non-active company shareholders or business partners. However, we consider that the legislation would not be effective in all intended circumstances.

Consider the following example. Mr & Mrs X are 50:50 shareholders in a small trading company. Mr X works full-time in the business and Mrs X only works 10 hours per week in the business performing administrative duties. The business makes annual profits of £60,000 (before salaries). Mr & Mrs X each take an annual salary of £25,000 from the business. The remainder of the profit (after tax liabilities) is distributed equally to Mr & Mrs X in the form of dividends.

Under the proposed s681B ITA 2007, income shifting will have occurred if:

- Mr X has entered into arrangements
- which he has the power to control and influence
- whereby he has foregone income ("the foregone income")
- the foregone income, or any income deriving from or otherwise representing any of the foregone income, becomes income of Mrs X ("the shifted income") and
- **the shifted income** consists of distributions of a company or profits of a partnership.

It is clear that the arrangements set out in the example above are not normal commercial arrangements. Mr X has arguably foregone some of the dividend income to which he is entitled, but he has also foregone salary as he makes a greater contribution to the business than Mrs X in terms of the number of hours worked and the value of his work to the business.

However, under the wording of the draft legislation, whilst it is possible to reallocate some of the dividends received by Mrs X to Mr X for tax purposes, it is not possible to reallocate any of her salary payment. This is because the salary received by Mrs X cannot be "shifted income" (which, by virtue of s681B (6), must be either distributions of a company or profits of a partnership) unless the word "distribution" in that sub-section is given a wider meaning than is the case in other parts of the legislation.

The arrangement in the example above is clearly not as tax-efficient as that entered into by the taxpayers in the *Jones v Garnett* case (where only minimal salaries were received) as employee's and employer's NICs are due on salary payments but not on dividends. Nevertheless, the arrangements are clearly of the type that the Government would like to attack as, if Mr X had received a "fair share" of the profits in the form of salary he would have been subject to tax at 40% on part of this (whereas all of the income received in the example is taxed at the basic rate).

Question 2 - Would the legislation capture situations that are not within the aim of removing the tax advantage gained by income shifting? If so, the Government would welcome examples, an explanation of why you believe these situations are not within the aim of the legislation and, if possible, any suggestions on how these situations may be effectively excluded from the legislation.

Application of the income shifting rules to investment income

From the statements made in the consultation document it is clear that the Government intends the draft legislation to only apply to **business** arrangements. However, we are concerned that, due to the current wording of the draft legislation, it could also be applied to investment income.

Under the proposed section 681B (6) ITA 2007, the new rules will apply to shifted income which consists of either distributions of a company or profits of a partnership.

There is no definition of the word "partnership" in the Taxes Acts and it is, therefore, sensible to apply the definition in the Partnership Act 1890 ("PA1890"). This states that:

"partnership is the relation which subsists between persons carrying on a business in common with a view of profit".

In other words, any commercial arrangement between two or more people with the intention of monetary gain is a partnership, irrespective of whether this is evidenced by a partnership agreement or other documentation.

Consider the case of Mr & Mrs Y who purchase a property which they intend to rent out on a long-term basis. Mr & Mrs Y provide the same amount of funds to purchase the property but Mr Y carries out all of the DIY involved in maintaining the property. Mr & Mrs Y split the rental income equally and report it as such in their self-assessment tax returns.

We realise that under section 5 of the Partnership Act 1907, joint ownership of an asset does not automatically constitute a partnership, but for this purpose we will assume that Mr & Mrs Y have read HMRC's Land and Property guidance (SA105) and accept that they are running a property business in partnership.

Under the proposed legislation, income has been shifted from Mr Y to Mrs Y and, if Mrs Y pays tax at a lower rate than Mr Y, then a re-allocation of the rental income may be required for tax purposes such that the majority is deemed to have been received by Mr Y.

This arrangement is clearly within the scope of the legislation because Mr & Mrs Y entered into a partnership when they purchased the property with the intention of renting it out. However, we assume that it is not the Government's intention that such investment type activities are caught by the new legislation.

We suggest that the Government clarifies whether or not investment income is to be subject to the income shifting rules. If it is not intended that investment income is to be caught, then we recommend that section 681B (6)(b) is amended to refer to "partnership profits arising from trading or professional activities".

This is an important issue as, without proper clarification, the draft legislation could theoretically be applied to many forms of joint investment income where funds have been aggregated by two or more individuals investing in partnership.

We recommend that clarification is provided through a tightening of the wording in the draft legislation. Further HMRC guidance on this point is not sufficient for this purpose as it would have no force in law.

Mis-match of dates for application to company distributions and partnership profits

We note that it is intended that the new legislation will apply to shifted income taxable in tax years 2008/09 onwards. The legislation will therefore apply to:

- company distributions received on or after 6 April 2008; and
- partnership profits subject to tax in the tax years 2008/09 onwards.

Under the normal basis period rules, profits of a partnership earned in respect of an accounting period ending in the year to 5 April 2009 will be treated as taxable in the tax year 2008/09. So, in the case of a partnership with an accounting period ending on 30 April 2008, all of the profits from this period will be subject to the income shifting rules. This is despite the fact that nearly two thirds of these profits will have been earned before the new rules were announced and eleven twelfths will have been earned before the legislation comes into force. Furthermore, these may already have been withdrawn by the partners.

We, therefore, suggest that transitional rules are included in the legislation to ensure that any partnership profits earned in respect of that part of an accounting period falling before 6 April 2008 are not subject to the new rules. This would then put companies and partnerships on an equal footing relating to the commencement date of the legislation.

A preferable course of action would be to defer the introduction of these measures by one year. This is not loophole plugging anti-avoidance legislation where HMRC has to move fast in order to prevent abuse; therefore, there is time for the measures to be introduced in a fair and considered way, taking the appropriate time in order to ensure that they operate correctly.

Question 3 - In what ways could the legislation and guidance provide greater clarity for businesses and their advisers, enabling them to understand when income has been shifted and what to do in these circumstances?

We consider that, whilst the overall intention of the draft legislation is clear, a number of the concepts and terms used are not clearly defined or explained, unless amendments are made. This could lead to considerable uncertainty as to when income shifting has occurred and what needs to be done when it has occurred.

It is important that the clarification requested is provided through changes to the draft legislation rather than further HMRC guidance as the latter does not have the force of law.

a) What types of income are covered by section 681B (6)?

These points have already been alluded to earlier in this submission but are covered again below for completeness sake.

Firstly, we assume that the term "distributions of a company" in sub-section (6)(a) has a similar meaning to that used in other areas of the legislation. For example, in section 254 ICTA 1988, a distribution is defined as "anything distributed out of the assets of the company (whether in cash or otherwise) in respect of shares in or securities of [a company]."

Specifically, we assume that a distribution of a company does not include a salary payment. If the Government considers that any payments other than dividends, or payments akin to dividends, should be included then the draft legislation should be amended to make this clear.

Secondly, we consider that the term "profits of a partnership" includes investment income. If the Government does not intend this to be the case then the draft legislation should be amended to specifically exclude this.

b) "Relevant arrangements"

Relevant arrangements are defined as "arrangements that are not genuine commercial arrangements and, *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."

We consider that the use of the phrase "it would be reasonable to draw the conclusion" in this context will create considerable uncertainty for taxpayers. It would seem that this phrase has been used so that the new rules will catch not only arrangements with a deliberate tax avoidance purpose, but also those where no tax advantage was intended by the participants.

We suggest that section 681E (1)(b) is amended to remove the words "it would be reasonable to draw the conclusion, from all the circumstances of the case, that".

c) "Genuine commercial arrangements"

Arrangements are exempted from being "relevant arrangements" if they are "genuine commercial arrangements". These are broadly stated to be arrangements effected in the course of a trade or business but not on terms other than those that would have been made between persons not connected with each other dealing at arm's length. In other words, to apply this exemption it is not sufficient that the owners of the business concerned are not connected with each other - they must also be operating on arm's length terms. Our concern is that many businesses will not feel sufficient certainty that they are operating on arm's length terms as there will be insufficient guidance to help them to interpret this phrase.

Although it would make the legislation more complicated, we consider that companies and partnerships should be exempted from the income shifting rules where none of the shareholders or partners are members of the same family or civil partnership and are not a cohabiting couple .
It would be necessary to introduce some form of connected persons test, such as in section 286 TCGA

1992 to define those arrangements which are not exempted. Although this might allow exempted businesses to abuse the position, we consider that the risk is low as the bounteous arrangements which the Government is most concerned about tend to be entered into only between family members.

d) "The power to control or influence the amount of shifted income"

The income shifting rules will only apply where an individual has the power to control or influence the amount of the income which has been shifted to another individual. There is very little guidance in the consultation document as to how this phrase should be interpreted. Paragraph B.34 states that it is to be wider than the definition of "control" in section 989 ITA 2007 but offers no further explanation.

Paragraph B.36 goes on to describe a situation where individual 1 has given away all of his/her shares in a company to Individual 2 but still retains the power to control and 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. However, what such actions might be is not explained.

In order to aid the clarity of the legislation we suggest that conditions B & C in section 681B are merged to read as follows:

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

(a) Individual 1 forgoes income ("the foregone income"), and
(b) Individual 1 intends that any of the foregone 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").

Question 4 - Can you suggest any practical steps that the Government could take to ensure that the administrative burdens of the proposed approach are minimised, while ensuring that its aims are achieved?

As stated above in response to question 3, we suggest that businesses which are not owned by fellow family members or members of a civil partnership or cohabiting couples should be exempted from the income shifting rules. This would ensure that all such businesses would not need to maintain the detailed records and documentation referred to later in these representations.

In the case of arrangements where income shifting has occurred it may be difficult to quantify the adjustment required to complete the relevant self-assessment returns. In respect of a company jointly held 50:50 by husband and wife where only one spouse works in and contributes to the business, this will be easy. However, where the two partners both contribute to the business but in different ways, this will be less straightforward.

In the Consultation Stage Impact Assessment on page 34 of the consultation document it is stated that "analysis of the data has identified 65,000 companies where income shifting is likely to be taking place. In addition, it is estimated that some 20,000 two person partnerships are displaying signs of income shifting". It is therefore clear that HMRC has sufficient information to risk-assess businesses to which the new rules may apply.

In the context of this, we suggest two possible approaches to ease the administrative burdens faced by taxpayers required to self-assess their position under the new regime.

1. Rules only to apply on notice delivered by an Officer of Revenue & Customs

Similar to the position with regards to the Transactions in Securities legislation, a provision could be included in the legislation such that a taxpayer is only required to apply the income shifting rules when they have been notified by an Officer that the rules may apply to them. However, this is unlikely to remove the need to maintain sufficient records and documents to refute any such challenge from HMRC and so may not provide significant benefit to taxpayers.

2. Provide a clearance procedure

A more beneficial option would be for HMRC to provide a form of clearance procedure such that taxpayers could agree with their Tax Inspector whether an income shift has occurred and, if so, the quantum of the tax adjustment required so that it can be correctly reflected in the taxpayer's self-assessment tax return. Provided the taxpayer has made a full and proper disclosure, the agreement could remain in force over a number of years unless the respective contributions of the owners of the business change significantly. At this point, the onus would be on the taxpayer to advise the Inspector of the change of circumstances.

The advantage of this approach is that, following agreement with the Inspector, the taxpayer would not need to keep detailed records in order to defend him/herself in the event of an HMRC enquiry. The taxpayer would just need to keep an overall watch on the position and alert the Inspector when significant changes occur.

In advance of the introduction of the new rules, HMRC could contact all those taxpayers it considers to be involved in income shifting to invite them to seek advance clearance on their tax position.

3. Specify the exact evidence that affected businesses should maintain

It is essential that details of the guidelines are included in the legislation or regulations as to what evidence needs to be supplied to HMRC in the case of an enquiry in order to provide greater certainty to business owners.

Where one is concerned with the services of, say, an accountant or a builder, there may be readily available evidence to determine the market rate for the taxpayer's responsibilities based on typical 'rates per hour'. However, in most cases, it will be almost impossible to ascertain "the going rate" for the services of someone who owns and runs their own business.

We therefore seek clarity from HMRC as to the evidence taxpayers would be expected to provide in these circumstances.

Question 5 - In situations where income shifting has occurred, are you aware of any practical problems that business owners may have in making their self-assessment returns correctly? If so, in what ways can the Government mitigate these problems?

The biggest problem that taxpayers will face under the new regime is determining the value of the contribution by each co-owner, to the business, in order to determine the value of the income shifting adjustment. The examples given in the consultation document are useful but are necessarily simplified in order to illustrate the rules. Real-life businesses are, by their very nature, much more complicated than this. Also, spouses will not typically hold formal meetings to discuss their business arrangements and will often ‘muck in’ as and where is necessary, rather than having clearly defined roles. This makes the quantification of their contributions to the business more difficult.

Paragraph B.49 of the consultation document points to three factors that business owners may wish to consider in assessing the value of their contribution to the business. These are the work done, the amount of capital invested and the amount of risk taken. Note that this paragraph says these are factors that “**might** be considered”. HMRC considers that there may be others but no guidance is given as to what these might be.

The examples in the consultation document look at the respective contributions of the business owners on a year-by-year basis. In Example 10 on page 27, for example, it is suggested that arrangements may cease to be at arm’s length over time if, for example, an individual ceases work in a partnership business but continues to receive the same profit share than when he/she was working full-time in the business. The position is complicated but still relatively manageable.

However, what happens if the business is carried on by a company and part of the profits are retained in the business? If they are paid out as dividends at a later date, the respective contributions of the business owners may have changed by the time the dividends are paid. How do you work out the income shifting adjustment in this situation – by reference to the respective contributions in the period when the income was foregone by individual 1 or when it was received by individual 2?

Clearly, every business is going to be different and we suggest that without an advanced clearance procedure, as referred to above, the whole system will become unworkable in practice.

Question 6 - Do you believe that the consultation stage impact assessment in Annex C accurately represents the likely impacts on business and the costs that they would incur? If not, what do you believe are the likely impacts and costs and for what reasons?

We believe that the administrative burden placed on businesses under the new regime is grossly underestimated in Annex C. HMRC has indicated that the cost will be a one-off transitional cost for each business to determine how the new rules will apply to them. In reality, however, there will be an on-going administrative burden in maintaining additional records and documents which taxpayers will require to defend themselves against an enquiry from HMRC. A list is set out at paragraph B.63 of the consultation document of documents that HMRC may wish to review in the event of an enquiry. Many of these are not kept by the typical family owned company, especially time records and the benchmarking of salaries to market rates.

Not only will documentation need to be maintained, business owners must also review their position on an ongoing basis and ensure that their respective rewards match their contributions to the business (or calculate adjustments to be included in their self-assessment tax returns).

We also consider that HMRC has underestimated its own costs in enforcing the new regime. As well as the cost of educating Inspectors on how to apply the new regime, any enquiries raised by Inspectors will need to be sufficiently detailed and involved to allow them to obtain a full understanding of the workings of the business and the appropriate allocation of reward between the business owners. However, having undertaken the necessary training programme, HMRC will have a pool of informed Inspectors available to consider advance clearance applications, should a clearance procedure be implemented as suggested.