

# Income shifting: a consultation on draft legislation

---

December 2007



HM TREASURY



HM Revenue  
& Customs





HM TREASURY



HM Revenue  
& Customs

---

# Income shifting: a consultation on draft legislation

December 2007

© Crown copyright 2007

The text in this document (excluding the Royal Coat of Arms and departmental logos) may be reproduced free of charge in any format or medium providing that it is reproduced accurately and not used in a misleading context. The material must be acknowledged as Crown copyright and the title of the document specified.

Any enquiries relating to the copyright in this document should be sent to:

Office of Public Sector Information  
Information Policy Team  
St Clements House  
2-16 Colegate  
Norwich  
NR3 1BQ

Fax: 01603 723000

E-mail: [HMSOlicensing@opsi.x.gsi.gov.uk](mailto:HMSOlicensing@opsi.x.gsi.gov.uk)

## **HM Treasury contacts**

This document can be found on the Treasury website at:

**[hm-treasury.gov.uk](http://hm-treasury.gov.uk)**

For general enquiries about HM Treasury and its work, contact:

Correspondence and Enquiry Unit  
HM Treasury  
1 Horse Guards Road  
London  
SW1A 2HQ

Tel: 020 7270 4558

Fax: 020 7270 4861

E-mail: [ceu.enquiries@hm-treasury.gov.uk](mailto:ceu.enquiries@hm-treasury.gov.uk)

Printed on at least 75% recycled paper.  
When you have finished with it please recycle it again.

ISBN 978-1-84532-365-3

PU345

# CONTENTS

---

		<b>Page</b>
Chapter 1	Government proposals on income shifting	<b>3</b>
Chapter 2	The consultation process	<b>9</b>
Annex A	Illustrative draft legislation	<b>11</b>
Annex B	Draft guidance	<b>13</b>
Annex C	Consultation stage impact assessment	<b>31</b>



# GOVERNMENT PROPOSALS ON INCOME SHIFTING

## INTRODUCTION

---

**The income tax system** **1.1** The Government believes that it is right for everyone to pay income tax on their own income. This principle, by which individuals are taxed on their income independently of others and of their personal choices, ensures that the income tax system is fair and remains progressive.

**Income shifting** **1.2** The Government believes that the fairness of the income tax system is undermined if some individuals are able to dissociate themselves from income that they would have received in order that the income is taxed in the hands of another individual at a lower rate. This is known as income shifting (or income splitting).

**1.3** Historically, income shifting has been achieved through the use of settlements, and the settlements legislation<sup>1</sup> aims to address this. It applies when an individual gains a tax advantage through the use of arrangements in which income is transferred to a spouse or civil partner, but the settlor retains an interest in that income or the underlying property from which the income is derived<sup>2</sup>. It also applies to arrangements under which income is paid to a minor child of the settlor<sup>3</sup>. The settlements legislation continues to address many forms of income shifting satisfactorily, but it does not apply to certain income shifting arrangements currently in use.

## INCOME SHIFTING WITHIN MODERN BUSINESSES

---

**Business structures** **1.4** In recent years there has been a growth in the number of small businesses establishing as companies. There are a number of reasons for this. For example, some businesses find that their clients prefer to transact with a corporate body; for others, the limited liability offered by a company is important. Partnerships, too, continue as a common vehicle for small businesses.

**1.5** However, the Government recognises that with the continuing growth of small businesses using the corporate or partnership form there are greater opportunities to shift income.

**Use of a company structure** **1.6** Where an individual establishes a business using a company structure, they may decide to introduce another individual as a second shareholder. For small businesses it is common for this individual to be a spouse, partner or other household member of the first individual. There are often legitimate commercial reasons for doing this, for example where the second individual contributes labour or capital to the business. In these situations the Government believes that it is right for the distributions from the company to reflect the contribution that both individuals have made.

**1.7** However, in some cases, the second individual plays either no role or only a minimal role in the business, with the first individual solely or mainly responsible for the activity of the business and for the generation of the income that is then distributed. Regardless of this, it is possible for the two individuals to arrange the distribution of salary and dividends from the company to gain a tax advantage, by the first individual

---

<sup>1</sup> Sections 619 to 648 Chapter 5 Part 5 Income Tax (Trading and Other Income) Act (ITTOIA)

<sup>2</sup> Section 624 ITTOIA

<sup>3</sup> Section 629 ITTOIA

forgoing income that can then be distributed to the second individual and taxed at a lower rate as a result. In these situations the Government considers that income has been shifted from the first individual to the second.

### Use of a partnership structure

**1.8** A similar outcome can arise if two or more individuals decide to establish a business in partnership form (including a Limited Liability Partnership). By securing agreement to a particular allocation of partnership profit, the first individual is able to forgo income in order that it is taxed on the second individual at a lower rate.

**1.9** Box 1.1 gives examples of these two scenarios and the tax advantage that may arise through this shifting of income. It is important to note that for demonstration purposes these examples are simplistic. In reality small business arrangements may be more complex.

#### Box 1.1: Examples of income shifting

Nina and Charlie are a married couple. Nina wishes to start up a business as a freelance writer. She sets this up, involving Charlie in the structure of the business although he does not play any role in it. These examples assume that neither Nina nor Charlie has any other income and the calculations of tax are based on 2007-2008 rates.

##### (a) Using a company structure

Nina and Charlie each buy 50 shares in an off-the-shelf company. The business makes £60,000 of profit in its first year and, in order to reduce her tax liability, Nina decides to distribute all of the profit to the shareholders, Charlie and herself, as dividends. They each receive £30,000 in dividends although Charlie has not contributed directly to the generation of the business's income.

There is no income tax charge on the dividends received because neither individual is a higher rate taxpayer. If Nina had paid all of the dividends to herself, she would have had a tax liability of £6,039. Alternatively, if Nina had traded as a sole trader, she would have had a personal tax liability of £15,414.

##### (b) Using a partnership structure

Rather than using a company structure, Nina sets up a partnership with Charlie. Again, the business generates £60,000 of profits and the profits are distributed 50:50.

Here Nina and Charlie have a combined tax liability of £10,344. If Nina had not formed a partnership with Charlie, and had traded as a sole-trader, she would have had a tax liability of £15,414 on the £60,000.

In both of the examples above, Nina has organised her business in such a way as to shift part of the income that she would otherwise have received to Charlie and therefore reduce her tax liability.

## THE GOVERNMENT'S APPROACH

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

**1.11** The Government is therefore keen to ensure that, in meeting its objective to provide a fair tax system by removing the tax advantage gained from income shifting, it takes account of the realities of running a business.

**A new approach**

**1.12** As described above, current business structures have presented opportunities to shift income in order to gain a tax advantage. The *Jones v Garnett* case looked in detail at one such situation. In this case, which considered the distributions made to the joint owners of Arctic Systems Ltd, HM Revenue and Customs (HMRC) sought to apply the settlements legislation to deem the dividends received by one shareholder as those of the other shareholder for income tax purposes. HMRC lost this case in the House of Lords.

**1.13** Following the House of Lords decision, it is now clear that the settlements legislation is not sufficient to address all cases of income shifting. The Government is committed to ensuring that, with clear and modern legislation, such cases can be dealt with effectively and that clarity can be given to businesses and their advisers. Therefore the Government is proposing to introduce new legislation effective from 6 April 2008, focused specifically on income shifting arrangements that make use of companies or partnerships to gain a tax advantage. An illustrative draft of this legislation is shown in Annex A.

**Outline of the proposed legislation**

**1.14** The intended outcome of the proposed legislation is to undo the tax advantage gained by income shifting arrangements. The legislation does not consider any situations where an arrangement has been made on a commercial or arm's length basis. Within the legislation there are several conditions, all of which must be met for the legislation to apply. In summary:

- Condition A – individual 1 is party to, or has power over the relevant arrangements;
- Condition B – individual 1 forgoes income and the forgone income is individual 2's for the relevant tax year;
- Condition C – individual 1 has the power to control the amount that is shifted; and
- Condition D – the shifted income consists of distributions of a company or profits of a partnership.

**1.15** Additionally, the tax paid by individual 1 and individual 2 must be less than it would have been had they not shifted income, i.e. a tax advantage must have been obtained. If all of these conditions are met the shifted income would be treated, for income tax purposes, as income of individual 1 and would not be taxed as income of individual 2. It is intended that the treatment of class 4 national insurance contributions would follow the tax treatment where a class 4 liability arises following the shifting of income.

## APPLYING THIS APPROACH IN PRACTICE

**1.16** The majority of business owners would be unaffected by the proposed legislation because they do not fulfil the conditions set out in the draft legislation. However, the Government recognises that for a minority of businesses there may be concern that distributions from the business fall within the scope of the legislation. To establish the correct treatment in these situations, it will be necessary to consider:

- Is one individual in a position to shift income, with power to control or influence any arrangements? In other words, can one individual decide or secure how the profits from the business are distributed?
- Has that individual forgone income that formed part of the second individual's income within an arrangement that would not be entered into at arm's length?
- Does the shifted income consist of distributions from a company (for example, dividends) or a share of partnership profits?
- Has a tax advantage occurred as a result of shifting the income from the first individual to the second individual?

**1.17** The answers to these questions will depend on the facts of each case. The draft guidance, in Annex B, sets out ways in which the Government believes that business owners and their advisers could establish whether income shifting has taken place, including factors which may be taken into account when considering the contribution of each individual to the business.

**1.18** The Government is keen to ensure that the proposed new legislation is clear and that administrative burdens on business are minimised. The Government would welcome views on whether the guidance achieves these aims.

**If income has been shifted**

**1.19** The effect of the legislation proposed is that where a distribution that has been made from a business represents shifted income, the individual who has forgone that income should include it on their self-assessment return at the end of the relevant year, for income tax purposes.

---

## QUESTIONS FOR CONSULTATION

---

**1.20** The Government is inviting comments from interested parties to ensure that the draft legislation, together with the guidance attached in Annex B, achieves the aims for which it has been designed.

**1.21** Specifically, the Government would welcome comments on the following questions:

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?



# 2

## THE CONSULTATION PROCESS

---

### PROCESS AND TIMETABLE FOR CONSULTATION

---

**2.1** The Government welcomes comments on the proposals in this consultation paper. Any comments should be sent to:

James Miller  
Income shifting consultation  
Room 2/N2  
HM Treasury  
1 Horse Guards Road  
London  
SW1A 2HQ

Alternatively, please email: [incomeshifting.consultation@hm-treasury.gov.uk](mailto:incomeshifting.consultation@hm-treasury.gov.uk)

Telephone enquiries: 020 7270 4400

**2.2** Comments should be received by 28 February 2008.

### Confidentiality disclosure

**2.3** Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

**2.4** If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals with, amongst other things, obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Treasury (HMT) or HM Revenue and Customs (HMRC).

**2.5** HMT and HMRC will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

### About the consultation process

**2.6** This consultation is being conducted in accordance with the consultation criteria in the Cabinet Office Code of Practice (see box 2.1). If you wish to access the full version of the Code you can obtain it at:

<http://bre.berr.gov.uk/regulation/consultation/code/index.asp>

**Box 2.1: The consultation criteria**

1. Consult widely throughout the process, allowing a minimum of 12 weeks for written consultation at least once during the development of the policy.
2. Be clear about who may be affected, what questions are being asked, and the timescale for responses.
3. Ensure that your consultation is clear, concise and widely accessible.
4. Give feedback regarding the responses received and how the consultation process influenced the policy.
5. Monitor your department's effectiveness at consultation, including through the use of a designated consultation co-ordinator.
6. Ensure your consultation follows better regulation best practice, including carrying out an impact assessment if appropriate.

## Complaints

**2.7** If you feel that the consultation process does not satisfy these criteria, or if you have any complaints about the process, please contact:

Duncan Calloway  
Better Regulation Unit  
HM Revenue & Customs  
Room 3/37  
100 Parliament Street  
London  
SW1A 2BQ

Email: [duncan.calloway1@hmrc.gsi.gov.uk](mailto:duncan.calloway1@hmrc.gsi.gov.uk)

Telephone: 020 7147 2389

**1 Income-shifting**

- (1) In Part 13 of ITA 2007 (tax avoidance), insert at the beginning –

## “CHAPTER A1

## INCOME-SHIFTING

**681A Overview of Chapter**

This Chapter makes provision for counteracting income tax advantages obtained by income-shifting.

**681B Income-shifting**

- (1) This Chapter applies where income is shifted from one individual (“Individual 1”) to another (“Individual 2”).
- (2) Income is shifted from Individual 1 to Individual 2 if conditions A to D are met.
- (3) Condition A is that Individual 1 –
  - (a) is a party to relevant arrangements, or
  - (b) has the power to control or influence relevant arrangements.
- (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”).
- (5) Condition C is that Individual 1 has the power to control or influence the amount of the shifted income.
- (6) Condition D is that the shifted income would consist of –
  - (a) distributions of a company, or
  - (b) profits of a partnership.
- (7) For the meaning of “relevant arrangements” and “forgoes income”, see sections 681E and 681F respectively.

**681C Tax effects of income-shifting**

- (1) The shifted income is to be treated for the purposes of income tax –
  - (a) as forming part of the income of Individual 1 for the relevant tax year, and
  - (b) as not forming part of the income of Individual 2 for that tax year.
- (2) This section is subject to section 681D (exemption where no tax advantage).

**681D Exemption: no tax advantage**

Section 681C does not apply where –

- (a) the total amount of income tax which would be payable by Individual 1 and Individual 2 for the relevant tax year if subsection (1) of that section did apply, is less than or equal to

- (b) the total amount of income tax which would be payable by them for that tax year if that subsection did not apply.

#### **681E Meaning of “relevant arrangements”**

- (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 that would have been made between persons not connected with each other dealing at arm’s length, or
  - (b) such as would not 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).

#### **681F Meaning of “forgoes income”**

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 the income but does not receive it, or
  - (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.”
- (2) The amendment made by subsection (1) has effect in relation to income which (apart from that amendment) would have formed part of the income of Individual 2 for the tax year 2008-09 or a later tax year.

# B

## DRAFT GUIDANCE

---

### HMRC guidance: tax advantages arising through the shifting of income from partnership profits and company distributions

**B.1** This is the first draft of guidance and it will be amended in light of suggestions and comments received during the consultation period.

**B.2** References in this guidance to “legislation” should be read as references to the draft legislation in Annex A.

<b>Contents</b>	PART 1	The income shifting legislation
	PART 2	Practical issues
	PART 3	Further examples

## PART I THE INCOME SHIFTING LEGISLATION

---

### Introduction

#### Purpose of the legislation

**B.3** The principle underpinning this legislation is straightforward. It starts from the proposition that income tax is intended to be a tax on income. Generally speaking, the charge on individuals is based on the income, profits or other amounts that individuals are entitled to receive.

**B.4** However, in some circumstances individuals are able to divert the income that they would have been entitled to receive to someone else. Where this occurs, the primary reason for this diversion may be to reduce the overall amount of income tax payable, typically by taking advantage of someone else’s personal allowances and lower tax bands.

**B.5** In these circumstances, the legislation is intended to counteract the tax advantages obtained by the diversion of income to other persons. The legislation describes the diversion of income from one person to another as “income shifting”.

#### To what income does it apply?

**B.6** The legislation is intended to apply to two forms of income:

- profits from a partnership; and
- company distributions, most commonly dividends.

#### What is outside the scope of the income shifting legislation?

**B.7** In general terms, the legislation would not apply to genuine commercial arrangements, or arrangements that are the same as those that would have been entered into in dealing with an unconnected party on an arm’s length basis. In addition, the legislation would not apply where:

- gaining a tax advantage is not the main or one of the main purposes of the arrangements;
- the individual whose income is shifted has no power to control or influence the amount of the income; or

- notwithstanding that income shifting has taken place, there is no overall tax advantage.

## An overview of how the legislation would work

**Income is shifted from one individual to another**

**B.8** The legislation would only apply to the shifting of partnership profits or dividend income between individuals, although the arrangements in place that enable the income to be shifted may involve one or more corporate entities or partnerships.

**B.9** Where an individual shifts income to more than one other individual, the legislation would apply to each stream of income received by each other individual in respect of the income receivable by them.

**B.10** The legislation would only apply to income shifting arising from arrangements where obtaining a tax advantage is the main purpose or one of the main purposes of those arrangements.

**B.11** The legislation is not intended to apply to genuine commercial arrangements, broadly where the share of overall income received by each individual is a fair and reasonable reflection of what they would be entitled to in a normal commercial arrangement, or where there is no overall tax advantage as a result of income shifting.

**B.12** Income is shifted from one individual to another only when all four of the following conditions are met:

- Condition A – an individual (individual 1) is party to arrangements or has the power to control or influence the arrangements with a view to obtaining a tax advantage;
- Condition B – individual 1 forgoes income with the result that it becomes part of the income of another individual (individual 2) for income tax purposes;
- Condition C – individual 1 has the power to control or influence the amount of the shifted income; and
- Condition D – the income being shifted consists of either profits from a partnership or company distributions (most commonly dividends).

**B.13** The legislation would apply to any income that forms part of individual 2's income on or after 6 April 2008, even where the shifted income is derived from an earlier period. For example, it would apply to a dividend paid to individual 2 on or after 6 April 2008 where the shifted income relates to the year ending 5 April 2008 or earlier.

## Detail of the legislation

**B.14** The circumstances in which the legislation is intended to apply are contained in section 681(B). The four conditions, A to D, must all be fulfilled for the legislation to apply.

**Condition A: relevant arrangements**

**B.15** Condition A applies where individual 1 is party to relevant arrangements, or has the power to control or influence the relevant arrangements. This is a factual test and depends on the circumstances in each case.

**B.16** Assessing whether individual 1 is a party to relevant arrangements is meant to be interpreted in the widest sense. Consequently, section 681E (6) makes clear that the

term “arrangements” includes any agreement, understanding, scheme, transaction or series of transactions, whether or not legally enforceable.

**B.17** Whether a transaction forms part of a series of transactions, or a scheme, or an arrangement, will be a question of fact. For example, it should be possible to make an assessment in any case where one transaction would not have taken place without another transaction, or would have taken place on different terms without that other transaction. However, the absence of such connection between transactions is not critical. There might still be a range of other factors that would lead to the conclusion that they formed part of a scheme or arrangements.

**B.18** In order to cover circumstances where arrangements or transactions take place in, or cover, more than one tax year the legislation does not provide any time limit. For example, individual 1 might be party to arrangements in year 1 but individual 2 does not receive the shifted income until the next, or a later, tax year.

**B.19** Relevant arrangements are defined at section 681E as arrangements that are not genuine commercial arrangements and where it would be reasonable to conclude from all the circumstances of the case that the purpose, or one of the main purposes, is the avoidance of tax or the reduction of a charge to income tax.

**B.20** Genuine commercial arrangements are defined in section 681E(2) in order to ensure that the legislation does not apply to arrangements that are made on terms that would have been made by individuals acting on an arm’s length basis. In other words, the arrangements are the same as those that the individual would have been willing to undertake with an unconnected third party, also known as on a “commercial basis”.

**B.21** Where the business is one of making investments, or a combination of managing investments and carrying on a trade then, to be considered as a genuine commercial arrangement, the individual doing the work and the individual for whom the work is done must not be connected with each other and must be dealing with each other on an arm’s length basis.

**B.22** 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. “Tax advantage” is not defined, 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.

**B.23** The purpose of the arrangements is determined by the purpose of the participants in entering into the arrangements and subsequent actions arising from those arrangements. For example, if any participant has a main purpose of achieving a tax advantage, that will constitute a main purpose of the arrangements.

**B.24** There is no single factor that determines whether the obtaining of a tax advantage is a main purpose of an arrangement. All the circumstances in which the arrangements were entered into need to be considered. The circumstances might include, but are not limited to:

- the overall commercial objective. This should be considered not only from the perspective of all the participants in the arrangements, but also from any wider perspective and for these purposes a commercial objective does not include tax mitigation;

- whether the objective is one which the parties involved might ordinarily be expected to have and which is genuinely being sought; or
- whether the objective is being fulfilled in a straightforward way or whether the introduction of any additional complex or costly steps would have taken place were it not for the tax advantage that could be obtained.

**B.25** In practical terms, in considering whether the obtaining of a tax advantage was the main purpose, or one of the main purposes, of the arrangements it would be necessary to consider a number of factors. Typically, these might include:

- whether the transaction giving rise to the advantage would have taken place at all;
- if so, whether the tax advantage would have been of the same amount; and
- whether the transaction would have been made under the same terms and conditions.

### Condition B: income forgone

**B.26** Condition B is fulfilled where there are relevant arrangements in which:

- individual 1 forgoes income; and
- the income forms part of the income of individual 2 for a tax year.

The rule is widely drawn to ensure that it covers circumstances where the income forgone changes form or is received either directly or indirectly by individual 2.

**B.27** “Forgoes income” is defined in Section 681F. This provides that any income that individual 1 might reasonably have expected to have received if the relevant arrangements had not been in place is regarded as income forgone. In particular, it provides that regard should be given to the work done by individual 1 and all other relevant circumstances.

**B.28** The definition relies on two tests. The first considers whether individual 1 is entitled to the income or would have been entitled to the income had it not been for the arrangements, but does not in fact receive it.

**B.29** The second test considers what individual 1 might reasonably have expected to receive after taking into account the work done and all relevant circumstances.

#### **Box B.1: Example A – a simple illustration of what is meant by “forgoes income”**

Individual 1 provides services as a widget consultant through his sole trader business. The turnover for the year is £80,000 and profits after expenses are £60,000. This is a straightforward example and it is clear that individual 1’s income is £60,000.

Now consider the same example as above, except this time individual 1 forms a partnership with individual 2 (but this could just as easily be a company). Individual 2 does not work and has no capital invested in the business. Individual 2’s involvement in the business is merely to enable income to be paid to individual 2 to utilise their personal allowances and lower rate bands. Again the profits for the year are £60,000, but this time split equally between the two partners in accordance with their agreed partnership-sharing ratio. Both individual 1 and individual 2 have received income for the year of £30,000. For the purposes of this legislation, individual 1 will be treated as having forgone income of £30,000 to individual 2.

**B.30** This example also illustrates that, in order to ascertain the amount of income forgone, the legislation looks through the form of the arrangements that may be in place in order to focus on their economic substance.

**B.31** On the basis that individual 1 has undertaken all of the work in the partnership and generated all of the profits, it would be reasonable to expect individual 1 to receive all of the profits from the partnership including the share of profits paid to individual 2. Individual 2's income is described, as in section 681B4(b), as shifted income, in this case quantified as £30,000.

**B.32** In practice, the facts in each case will often be more complex than those in example A. Further guidance on how to quantify "shifted income" is set out in part 2 of this guidance.

**Condition C:  
influencing the  
amounts of  
shifted income**

**B.33** Condition C is intended to ensure that the legislation only applies in circumstances where individual 1 has the power to control or influence the amount of the shifted income. This rule is necessary to ensure that the legislation does not apply where individual 1 has entered into arrangements but cannot subsequently affect the income received by individual 2. An example of this is shown below.

**Box B.2: Example B – the power to control or influence the amount of shifted income**

Individual 1 owns 1000 shares in a major publicly listed company as an investor and gives 250 of these shares to individual 2, who in this example is her husband. Neither individual 1 nor individual 2 works for the company and, at some stage after the gift is made, the company declares a dividend, which is paid to individual 2. It is clear from this example that individual 1 cannot affect the timing or level of dividend declared by the company, as would be the case for any other minor investor. Consequently condition C is not met, so the new legislation would not apply in such circumstances.

In contrast, using the same scenario as above except that this time individual 1 owns 100% of the share capital in her private company and gives 250 shares to individual 2 (representing 25% of the share capital of the company). Individual 1 is able to affect both the level and timing of the dividend payable by the company and, for the purposes of the new legislation, condition C would be met.

**B.34** The term "power to control or influence" is not defined and is intended to be interpreted in its widest sense. In particular, it is intended to go wider than the definition of "control" contained in section 989 Income Taxes Act 2007 to ensure that it covers circumstances where individual 1 can affect the timing, amount and direction of the income being shifted to individual 2.

**B.35** Whether individual 1 has the power to control or influence the amount of shifted income is a question of fact. In the first scenario in example B, individual 1 is a minority shareholder in a listed company and the dividends are declared independently of any action taken by individual 1. In these circumstances it is clear that individual 1 does not have the power to control or influence any dividends paid to individual 2 after the shares have been gifted. In this context the timing of the gift is not an issue.

**B.36** In contrast, in the second scenario in example B individual 1 retains a majority holding in her private company. Therefore she has the power to control and determine both the timing and level of dividends payable in respect of the shares given to individual 2. 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.

**B.37** 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.

**B.38** Condition D is a straightforward factual test. It is fulfilled if the shifted income received by individual 2 is either:

- a share of the income profits from a partnership (including a Limited Liability Partnership); or
- a distribution (most commonly a dividend) as defined in section 989 Income Taxes Act 2007.

## Tax effects of the conditions

**B.39** Where it has been established that income shifting has taken place, section 681C provides the rules for dealing with the income tax consequences. There are two steps to this.

**B.40** The first step considers individual 1 and treats the shifted income as part of their income for the relevant tax year. So in example A above, individual 1 would be treated as having income of £60,000, made up of £30,000 as his share of the partnership profits plus the shifted income of £30,000.

**B.41** The second step is designed to avoid taxing the same income twice. The shifted income is treated as not forming part of individual 2's income for the relevant tax year. Again, in example A, the legislation would treat individual 2 as having income of £0, as all of the income received was shifted income, which is now being treated as individual 1's income.

**B.42** There is no re-categorisation of the income shifted. The legislation treats the income received by individual 2 as if it were individual 1's income on a like for like basis. For example, the shifted income received by individual 2 may be dividends, in which case individual 1 would be treated as having received those dividends for tax purposes.

**B.43** Condition A requires that the main purpose or one of the main purposes of the arrangement(s) is to gain a tax advantage. This is further reinforced by the exemption contained in section 681D, which dis-applies section 681C if there is no overall income tax advantage even if all of the conditions A to D in section 681B have been met. The exemption applies when the total amount of income tax that would have been payable by individual 1 and individual 2 before applying the income shifting legislation is the same or less than the income tax payable by them with the application of the legislation.

### Condition D: partnership profits or company distributions

**Box B.3: Example C – exemption from the new legislation**

Individual 1 and individual 2 are the sole shareholders in their privately owned company. After reviewing their circumstances they agree that individual 1, for the purposes of the new legislation, has shifted income of £20,000 in the form of dividends to individual 2. Both individuals are higher rate taxpayers before taking into account the additional tax due in respect of this shifted income. In this case, the income tax due on the whole of the shifted income will be the same amount regardless of whether individual 1 or individual 2 pays the tax. Consequently, the exemption applies.

**B.44** The exemption in section 681D refers to “the total amount of income tax which would be payable by individual 1 and individual 2 for the relevant tax year”. In calculating this, the fact that individual 2 may offset tax due on the shifted income by using losses available to them, or that they are not liable to UK income tax (for example, because they are resident outside the UK for tax purposes) is taken into account.

## PART 2: PRACTICAL ISSUES

---

### Record keeping

**B.45** The income shifting legislation does not mean that businesses will have to maintain any additional records. In the vast majority of cases it should be clear from the existing business records, other documents and/or agreements whether the new legislation applies or not. Broadly speaking, the new legislation will only apply to those individuals who have taken deliberate steps to shift their income for the purposes of gaining a tax advantage.

**B.46** Where income shifting has taken place, individual 1 and individual 2 will need to record the details on their respective self-assessment tax returns. The normal self-assessment record requirements apply and the individuals should keep sufficient records to support any entry on their tax returns.

### Quantification of the shifted income

**B.47** It is the responsibility of individual 1 to determine the amount of income shifted and to make the appropriate adjustments for self-assessment purposes. The legislation deliberately does not prescribe a formula for quantifying the level of shifted income because the facts and circumstances will be different in each case.

**B.48** HM Revenue & Customs (HMRC) expects individuals, together with their advisers, to use their own judgement in working out the level of shifted income. In doing so, they must adopt a reasonable basis for any conclusions reached.

**B.49** Generally, there are three factors that might be considered in assessing whether the calculation of the amount of shifted income is reasonable. Firstly, it is clear that individuals may play a wide variety of roles within businesses, adapting where necessary to the needs of the business. In these circumstances, the first question that might be asked is whether the work done by individual 2 reasonably justifies the level of reward received, taking into account:

- the type of work undertaken;
- the amount of work done; and
- the extent of their responsibility for making key decisions in the running of the business.

**B.50** Those in the business are in the best position to assess the duties and work done by individual 2. The work carried out may often be a significant consideration, particularly in situations involving businesses that have little or no capital or assets and rely heavily on individual 1 to generate the income of that business.

**B.51** Second, it might be appropriate to consider the amount of capital that individual 2 has invested in the business. For example, considering whether individual 2 has contributed capital in the business, including the source of any capital contributed or lent, which may warrant a particular level of return, might be a way of assessing their value (or part of their value) to the business. This will be an important factor when considering businesses that have significant capital and assets, including goodwill.

**B.52** A third question might be about the extent to which individual 2 takes on risk relating to the business and, as such, the extent to which this is rewarded through

remuneration. This might include using a personal asset (including a jointly owned one such as a house) as collateral for a business loan. The risks that should be considered are ones that arise on a commercial basis.

**B.53** These questions are not intended to be an exhaustive list of the factors to be considered in assessing the amount of the shifted income, but should be relevant in one permutation or another in most cases. The following example illustrates how some of these factors may be used in assessing the amount of the shifted income. There will be other ways in which an individual may be able to quantify the level of shifted income and this will ultimately depend on the nature of the business and circumstances of the individuals concerned. Whatever basis is adopted, it should take account of all of the facts in each case.

**Box B.4: Example D – quantifying shifted income**

The following situations are examples of what may be considered a reasonable basis for quantifying shifted income. They are for illustrative purposes only.

**Scenario 1:** individual 1 and individual 2 form a company, each owning fifty £1 ordinary shares. The business of the company is to provide the personal services of individual 1. Individual 2 spends around five hours a week on back office duties for the business. In the first year they each receive a salary of £5,000 and dividends of £30,000. The salary received by individual 2 is considered to be the market rate given the nature of the work done and time spent doing it. The company has no significant assets or liabilities other than the personal goodwill of individual 1.

If individual 2 has no capital in the business and bears no risk the whole of the £30,000 would be treated as shifted income because individual 2 is already receiving a market rate for the work done, has no capital in the business and bears no risk.

**Scenario 2:** as above, except this time the market rate for the work done by individual 2 is considered to be £15,000. The shifted income would be £20,000 (i.e. £35,000 – £15,000 salary).

**Scenario 3:** as above, except this time individual 2 has £20,000 of capital invested in the business, which would have otherwise attracted a return of 10% per year if invested elsewhere (i.e. £2,000). The shifted income is £28,000 (i.e. £35,000 – £5,000 salary – £2,000 return).

**Scenario 4:** as above, except this time individual 2 has agreed to secure a business loan of £100,000 against the value of their home. The bank charges an interest rate of 10% on this secured loan, costing £10,000, but their normal unsecured rate is 22%. The shifted income is £18,000 (i.e. £35,000 – £5,000 salary – £12,000 (which is the difference between 22% and 10% on the loan of £100,000)).

**Scenario 5:** as above, except this time individual 2 has loaned the business £100,000. The business bank unsecured lending rate for small business is 20%. The shifted income is £10,000 (i.e. £35,000 – £5,000 – £20,000).

**Scenario 6:** as above, except this time individual 2 has capital in the business of £20,000 and has agreed to secure a business loan of £100,000 against the value of their home. Again the bank charges an interest rate of 10% on this secured loan, costing £10,000, but their normal unsecured rate is 22%. The shifted income is £16,000 (i.e. £35,000 – £5,000 salary – £2,000 to take account of the capital invested in the business – £12,000 to take account of the risks taken in the business).

## Entries on self-assessment returns

**B.54** Where income received reflects fairly and reasonably what individuals would be entitled to in a normal commercial arrangement, then no adjustment to that income should be made to self-assessment returns.

**B.55** Where income shifting has taken place then, in the case of a distribution from a company, individual 1 will need to increase the amount for income from distributions (typically dividends) on their return to take account of the shifted income, including the calculation of the tax credit. Individual 2 will need to reduce the figures for income from distributions by the corresponding amounts.

**B.56** In the case of profits from a partnership, individual 1 will need to increase the figure for partnership profits on their return to take account of the shifted income and individual 2 will need to reduce the figure for partnership profits by the corresponding amount.

**B.57** In both cases, each individual will need to provide an explanation of what they have done using the white box on the return and identify the details of the other individual involved in the shifting of income. Further guidance on completing self-assessment returns will be published in due course.

**B.58** In cases where the individuals do not receive a self-assessment return they should contact HMRC. Where individual 1 is concerned, this will be to notify HMRC that they have chargeable income on which they have not paid tax. In the case of individual 2, this is to enable a claim for any tax repayment that may be due as a consequence of tax paid on income that should be chargeable on individual 1. In both cases they will need to provide full details of the other individual involved in the income shifting.

## How will individuals know if the other individual has shifted income?

**B.59** The legislation would only apply to those individuals who have taken deliberate steps to shift income for the purposes of gaining a tax advantage. Accordingly, most individuals should know if they have been involved in income shifting.

**B.60** However, there may be cases in which individual 1 has shifted income to individual 2 without the latter's knowledge. In these cases, individual 1 has a responsibility to inform individual 2 what has happened and the amount of the income to be re-allocated.

**B.61** In the rare case where individual 2 believes they may have been the recipient of shifted income from individual 1, without individual 1's knowledge, they should verify this with individual 1 before making any adjustment to their return.

## Disagreement between individual 1 and individual 2

**B.62** Each individual is responsible for completing their own self-assessment return and will be responsible for providing details of any other parties involved in the income shifting. In cases where the individuals have used different amounts for the shifted income in their respective tax returns, HMRC may intervene through the normal enquiry process to ensure that a consistent approach is adopted for both individuals.

This may involve an adjustment to the level of shifted income used by either individual or both depending on the facts in each case.

## HMRC enquiries

**B.63** HMRC may enquire into whether the approach adopted in assessing the amount of the shifted income was reasonable. If so, HMRC may ask to see the underlying records and other factors that have been used to assess the amount of income shifted. In addition, HMRC may ask for sight of any business records or other documents that might be relevant in assessing the amount of income shifted. This might include any of the following:

- documentation showing how an individual has arrived at the amount of the income shifted;
- documentation that demonstrates the nature and extent of the work done by individual 2, which may include contracts of employment, time sheets, board minutes, any research done on the market rates of pay for the duties undertaken by individual 2 etc.;
- documentation that demonstrates the amount of capital or loans invested in the business by individual 2, which may include copies of accounts, bank statements, loan agreements, shareholder or partnership agreements; and
- documentation that demonstrates the nature and amount of personal guarantees provided by individual 2, which may include copies of accounts, bank statements, loan agreements, shareholder or partnership agreements.

## Boundary with existing legislation

**Settlements legislation** **B.64** There will be no change in the way in which HMRC will view or apply the existing settlements legislation. The income shifting legislation would only apply if a tax advantage were still obtained from income shifting after taking into account the rules contained in the existing settlements legislation.

**Managed Service Company legislation** **B.65** Following Finance Act 2007, any company within the statutory definition of a Managed Service Company must from 6 April 2007 treat all payments or benefits made to a worker (the person or persons whose services have generated the company's income), or an associate, as earnings from employment of the worker. Where the legislation applies, and all of the income is treated as employment income of the worker, there is no need to consider other income shifting rules.

## Income shifting by gift

**B.66** Generally, income arising from the gift of assets will be outside the scope of the new legislation. However, the legislation may apply to income shifting arising from gifts that form part of an arrangement resulting in income being received by individual 2 in the form of a distribution from a company or a share of partnership profits.

## PART 3: EXAMPLES ILLUSTRATING THE SCOPE OF THE LEGISLATION

---

**B.67** The following examples are included to further illustrate the scope of the legislation. These do not constitute an exhaustive list and the application of the legislation would depend upon the facts in each case.

### Examples involving partnerships

**Example 1 B.68** This example illustrates a scenario that would be **outside the income shifting legislation** because there is no evidence of any arrangements with the object of securing a tax advantage.

**B.69** Individual 1 and individual 2 form a partnership to provide graphic design services. Each introduces £100 of capital into the business. Individual 1 provides the graphic design services to customers and individual 2 manages and promotes the business of the partnership. They both work full-time and develop the business together. Trading profits for the year are £80,000, which are split between individual 1 and individual 2 equally (i.e. each partner receives £40,000).

**B.70** The new legislation would not apply in this case because income has not been shifted. The share of profits received by individual 1 and individual 2 reflects the balance of labour and capital put into the business. The arrangement between individual 1 and individual 2 is a commercial one, which means that the test in condition A of section 681B has not been met.

**Example 2 B.71** This example illustrates a scenario that would be **covered by the income shifting legislation**. Despite each partner introducing equal capital to the business, a tax advantage is obtained through a division of income between the partners that does not reflect what they would be entitled to in a normal commercial arrangement. This is because of the differing levels of labour they contribute.

**B.72** Individual 1 and individual 2 form a partnership to provide graphic design services. Each spouse introduces £100 of capital into the business. Individual 1, who is a graphic designer, carries on the trade of the partnership while individual 2 does no work for the partnership. Trading profits for the year are £80,000, which are split between individual 1 and individual 2 equally (i.e. each partner receives £40,000).

**B.73** The new legislation would apply in this case because income has been shifted. The share of profits received by individual 1 and individual 2 does not reflect the balance of labour and capital put into the business. The arrangement between individual 1 and individual 2 appears to be non-commercial and has enabled individual 1 to forgo income that they should otherwise have received.

**Example 3 B.74** This example illustrates a scenario that would be **covered by the income shifting legislation**. Despite each partner providing equal labour for the business, a tax advantage is obtained through a division of income between the partners that does not reflect what they would be entitled to in a normal commercial arrangement. This is because of the differing levels of capital they have introduced to the business.

**B.75** Individual 1 and individual 2 form a partnership and start trading as a local grocery. Individual 1 introduces £200,000 of capital into the business, which is used to acquire the shop premises and stock. Individual 1 and individual 2 both work full time in the business and develop it together. Neither individual 1 nor individual 2 bring any

special skills into the business. Trading profits for the year are £80,000, which are split between individual 1 and individual 2 equally (i.e. each partner receives £40,000).

**B.76** The new legislation would apply in this case because income has been shifted. The profit share received by individual 1 and individual 2 do not reflect the balance of labour and capital put into the business. The arrangement whereby individual 2 is entitled to an equal share of the profits and a return on capital of the business even though individual 2 has not contributed any capital appears to be non-commercial. Individual 1 has forgone income that individual 1 may have otherwise received in relation to the capital contribution (i.e. a return on individual 1's capital).

**Example 4 B.77** This example illustrates a scenario that would be **outside the income shifting legislation**. Although the division of profits is unequal and does not appear to reflect the normal commercial position that would be expected (where the same capital and labour is contributed by each partner), a tax advantage is not obtained.

**B.78** Individual 1 and individual 2 form a partnership and start trading as a local grocery. Individual 1 and individual 2 each introduce £100,000 of capital into the business, which is used to acquire the shop premises and stock. Individual 1 and individual 2 both work full time in the business and develop it together. Neither individual 1 nor individual 2 bring any specialist skills into the business. Trading profits for the year are £40,000, which, under the partnership agreement, are allocated 1/8 (£5,000) to individual 1 and 7/8 (£35,000) to individual 2. The partnership agreement entitles individual 1 and individual 2 to an equal share of the capital value of the business and its assets, including any cash in the partnership.

**B.79** The shares of profit received by individual 1 and individual 2 do not reflect the balance of labour and capital put into the business. The arrangement appears to be non-commercial and this has enabled individual 1 to forgo income that they would otherwise have received as an equal partner in the business. Therefore it would appear that the legislation would apply. However, the combined tax payable by individual 1 & individual 2 is the same as would have been paid had the income not been shifted and therefore the exemption at Section 681D applies.

**Example 5 B.80** This example illustrates a scenario that would be **outside the income shifting legislation**. Despite each partner contributing different levels of capital and labour, there is no evidence of arrangements set up with the object of securing a tax advantage. The income received by each constitutes a fair commercial arrangement.

**B.81** Individual 1 and individual 2 form a partnership to provide graphic design services. Individual 2 introduces £200,000 of capital into the business. Individual 1, who is a graphic designer, carries on the trade of the partnership while individual 2 does not work for the partnership. Trading profits for the year are £70,000, which are split between individual 1 and individual 2 equally, (i.e. each partner receives £35,000). £35,000 is considered an arm's length return on individual 2's investment of £200,000.

**B.82** The new legislation would not apply in this case because income has not been shifted. The arrangement between individual 1 and individual 2 appears to be commercial as each partner receives an equal share of profits having contributed equally to the partnership, albeit in different ways.

**Example 6 B.83** This example illustrates a scenario that would be **outside the income shifting legislation**. No tax advantage is obtained despite payments being made to parties connected to a partnership at a non-commercial rate.

**B.84** Individual 1 and individual 2 are in partnership running a decorating business. The business wins a contract with a tight timescale and some of individual 1's relatives assist them with the contract to complete it in time. The relatives are paid a nominal amount for the help, thus reducing the eventual partnership profits.

**B.85** Individual 1 has used their control of the business to shift income to people connected to them at a non-commercial rate. However, this would not be within the scope of the legislation as no tax advantage is sought or obtained despite the amounts paid being below a commercial rate.

## Examples involving companies

**Example 7 B.86** This example illustrates a scenario that would be **covered by the income shifting legislation**. A tax advantage is obtained through a division of income between shareholders that does not reflect the normal commercial arrangement that would be expected given the different levels of capital and labour contributed by each.

**B.87** Individual 1 and individual 2 set up a company to exploit the personal services of individual 1, who is a graphic designer. The ordinary share capital is £1, consisting of one hundred ordinary 1p shares. Individual 1 and individual 2 each own 50% of the share capital. Individual 1 carries on the trade of the company, working full time, while individual 2 does not do any work for the company. Trading profits for the year are £80,000, after taking into account a salary of £10,000 for individual 1. Dividends of £35,000 each are declared and subsequently paid to individual 1 and individual 2 for that year.

**B.88** The new legislation would apply in this case because income has been shifted. The share of profits received by individual 1 and individual 2 does not reflect the balance of labour and capital put into the business. The arrangement between individual 1 and individual 2 appears to be non-commercial and has enabled individual 1 to forgo income that they would have reasonably been expected to receive given the specialist skills employed in the business. As a shareholder of the company, individual 2 is entitled to a dividend equal to the one received by individual 1, but unless there are other factors involved, there does not appear to be a commercial justification for these arrangements.

**Example 8 B.89** This example illustrates a scenario that would be **outside the income shifting legislation**. No tax advantage is obtained and no income shifted despite each shareholder contributing different levels of labour and the work of one influencing the value of distribution to another, because the overall income received by each appears to constitute a fair commercial arrangement.

**B.90** Individual 1 and individual 2 set up a company and start trading as a plumbers merchant. They each introduce capital of £50,000 into the business, which is used to acquire the shop premises and stock. Individual 1 works full time for the business and individual 2 works one day a week. The success of the business relies heavily on the skill and personal contacts of individual 1, who is a qualified plumber. Trading profits for the year are £40,000 after taking into account salaries of £40,000 for individual 1 and £10,000 for individual 2 (both salaries are at market rates). Dividends of £20,000 are declared and subsequently divided evenly between individual 1 and individual 2.

**B.91** The new legislation would not apply in this case because income has not been shifted. The arrangement between individual 1 and individual 2 is on a commercial basis. Individual 1 receives a market rate salary for their work and shares dividends with

individual 2 as equal shareholders in a company where they have introduced an equal amount of capital.

**B.92** The legislation should not capture instances where an individual works for a company on an arm's length basis but, through their work, they significantly influence the value of the distributions from the company to another individual.

**Example 9 B.93** This example illustrates a scenario that would be **outside the income shifting legislation**. No tax advantage is obtained despite payments being made to parties connected to controlling directors in a company at a non-commercial rate.

**B.94** Individual 1 is the 100% shareholder director of a stone masonry company. The children of individual 1 (individual 2 and individual 3) work for the company and receive a salary at below a commercial rate for the work they do. Those salaries reduce the net profits available for distribution. Consequently, it might be argued that individual 1 has used their control of the business to shift income to persons connected with them and that this is not a genuine commercial arrangement.

**B.95** However, this example is clearly not covered by the legislation. Individual 1 does not forgo income to individual 2 and individual 3. Additionally, it would not be reasonable to argue that the arrangement is in place to gain a tax advantage. Furthermore, the payments to individual 2 and individual 3 are not distributions of company profits. That the arrangement is non-commercial does not bring the example into the scope of the legislation in itself.

## Examples involving changes in arrangements over different periods

**Example 10 B.96** This example illustrates a scenario that would be **covered by the income shifting legislation**. A tax advantage is obtained when the division of income between partners fails to keep up with the changing level of labour contributed by each that would be reflected in a normal commercial remuneration arrangement.

**B.97** In year one, individual 1 and individual 2 form a partnership to provide graphic design services. Each individual introduces £100 of capital into the business. Individual 1, who is a graphic designer, carries on the trade of the partnership while individual 2 manages and promotes the business of the partnership. They both work full time and develop the business together. Trading profits for the first three years are £80,000 per year, which are shared between individual 1 and individual 2 equally. In year four, individual 2 decides to stop working for the business, but continues to retain a partnership share in the business. The trading profit for year four is £80,000, which is wholly attributable to the work done by individual 1 and, as in previous years, profits are shared equally between individual 1 and individual 2.

**B.98** Income shifting has not occurred in years one to three because the arrangements were fully commercial. In year four, while there is no change to the ownership of the partnership or individual 2's legal entitlement to the profit share, there is a change in the wider arrangements because individual 2 has stopped working for the partnership. Income shifting has occurred in year four because the profits attributed to individual 2 are not commensurate with their contribution to the partnership.

**Example 11 B.99** This example illustrates a scenario that would be **outside the income shifting legislation**. No tax advantage is obtained and no income shifted despite a change in the level of labour contributed by the partners. The division of overall income between

partners keeps up with the changing level of labour contributed by each and thus reflects what would be expected in a normal commercial remuneration arrangement.

**B.100** In year one individual 1 and individual 2 form a partnership to provide graphic design services. Each individual introduces £25,000 of capital into the business. Individual 1, who is a graphic designer, carries on the trade of the partnership while individual 2 manages and promotes the business of the partnership. They both work full time and develop the business together. Trading profits for the first three years are £80,000 per year, which are shared equally between individual 1 and individual 2. In year four, individual 2 decides to work for the business on a part time basis, but continues to retain a partnership share in the business. Individual 2 agrees to receive a lower share of the profits to reflect their reduced contribution to the business. The trading profits for year four are £80,000 and it is decided that the profits should be shared between individual 1 and individual 2 on a 70:30 basis to reflect their respective contributions to the business for that year.

**B.101** The new legislation would not apply in this case because income has not been shifted. The arrangement was commercial in years one to three and continues to be commercial in year four.

**Example 12 B.102** This example illustrates a scenario that may be **covered by the income shifting legislation**. A tax advantage is obtained when the division of income between partners fails to keep up with the changing levels of capital contributed by each that would be reflected in a normal commercial remuneration arrangement.

**B.103** In year one individual 1 and individual 2 form a partnership to provide graphic design services. Each individual introduces £50,000 of capital into the business. Individual 1, who is a graphic designer, carries on the trade of the partnership while individual 2 manages and promotes the business of the partnership. They both work full time and develop the business together. Trading profits for the first three years are £80,000 per year, which are split between individual 1 and individual 2 equally. In year four, individual 2 decides that they do not want to risk their capital in the business and they withdraw it from the business. Both individual 1 and individual 2 continue to work in the business as before, but now only individual 1 has capital in the partnership. Despite this, the profit is shared equally between individual 1 and individual 2. The trading profits for year four are £80,000, with each partner receiving £40,000.

**B.104** Income has not been shifted in years one to three, as the arrangements were commercial. Whether the removal of capital from the business by individual 2 in year four is sufficient to make the arrangements non-commercial will depend on the facts. Initially, the arrangement may appear to be non-commercial because individual 1 has contributed labour and capital while individual 2 has only contributed their labour and the legislation may apply. However, where there are other factors that indicate that the arrangements remain commercial, the legislation may not apply.

**Example 13 B.105** This example illustrates a scenario that would be **outside the income shifting legislation**. No tax advantage is obtained and no income shifted despite a change in the level of capital contributed by the partners. The division of overall income between partners keeps up with the changing level of capital contributed by each and thus reflects what would be expected in a normal commercial remuneration arrangement.

**B.106** In year one individual 1 and individual 2 form a partnership to provide graphic design services. Each individual introduces £50,000 of capital into the business. Individual 1, who is a graphic designer, carries on the trade of the partnership while

individual 2 manages and promotes the business of the partnership. They both work full time and develop the business together. Trading profits for the first three years are £80,000 per year, which are shared equally between individual 1 and individual 2. In year four, individual 2 decides they do not want to risk their capital in the business and it is withdrawn. The business makes trading profits of £80,000. This time the profits are split between individual 1 and individual 2 to reflect their contributions to the partnership with individual 1 receiving £45,000 and individual 2 receiving £35,000.

**B.107** The new legislation would not apply in this case because income has not been shifted. The arrangement was commercial in years one to three and continues to be commercial in year four.

**Example 14 B.108** This example illustrates a scenario where, despite the level of overall income received by each partner failing to reflect changes in labour contributed by each, the question of whether the income shifting legislation would apply **depends on the specific circumstances of each case.**

**B.109** In year one individual 1 and individual 2 form a partnership to provide graphic design services. Each individual introduces £50,000 of capital into the business. Individual 1, who is a graphic designer, carries on the trade of the partnership while individual 2 manages and promotes the business of the partnership. They both work full time and develop the business together. Trading profits for the first three years are £80,000 per year, which are shared equally. In year four, individual 2 does not work for a year and, during that time, individual 1 continues to work in the business providing the graphic design services to customers as before, but also now manages and promotes the business of the partnership on their own. However, profits are still shared equally between individual 1 and individual 2. The trading profits for year four are £80,000, with each partner receiving £40,000. In year five, individual 1 returns to work for the business. The business again makes trading profits of £80,000, which continue to be shared equally.

**B.110** Income has not been shifted in years one to three, as the arrangements were commercial. Whether individual 2 taking the year off work in year four is sufficient to make the arrangements non-commercial will depend on the facts. Initially the arrangements may appear to be non-commercial because individual 1 has contributed labour and capital while individual 2 has only contributed their capital, and the legislation may apply. However there will be instances where this is not the case and the arrangements would continue to be commercial, so the legislation would not apply. For example, the legislation would not apply when the time off is for maternity or sick leave. The legislation may apply in situations where there is not a commercial rationale for individual 2's leave that would otherwise justify an individual not working in the business for a year yet continuing to receive a full share of the profit. In year five, the arrangements are back on a commercial footing and the legislation would not apply.

**Example 15 B.111** This example illustrates a scenario that would be **outside the income shifting legislation.** No tax advantage is obtained and no income shifted despite one of the partners stopping work within the business. The division of overall income between partners keeps up with the changing level of labour contributed by each and thus reflects what would be expected in a normal commercial remuneration arrangement.

**B.112** Individual 1 and individual 2 found a company. They are both involved in building the business over a number of years before individual 2 stops working for the company. Individual 1 continues to work in the business and draws a market rate

salary. Dividends are distributed equally to individual 1 and individual 2, as they are both joint and equal owners of the company.

**B.113** The new legislation would not apply in this case because income has not been shifted. Individual 2 has helped to develop and build the business and would have capital in the company. Individual 1 is receiving a market rate return for their services to the company. The dividends received by individual 2 are a return on their investment.

### Other examples

**Example 16 B.114** This example illustrates that the income shifting **legislation would not be circumvented by the use of a Personal Service Company (PSC)** although the applicability of the legislation will depend on the facts of each individual case.

**B.115** Individual 1 is the sole shareholder and employee of a PSC. The PSC enters into a non-commercial arrangement, through a contract to provide services, with a second company that is wholly or partly owned by individual 2. This arrangement enables individual 1, through the PSC, to reduce their income and allows income to flow to individual 2 through their ownership of the second company through the use of dividends. Individual 1 may have been trading through the PSC for a number of years prior to entering into this arrangement.

**B.116** The legislation may apply in this situation if individual 1 is in a non-commercial arrangement and income is flowing to individual 2, but this would depend on the individual facts of the case. A review of this situation by either individual 1 or HMRC should take account of everything that facilitates the income flow to individual 2. For example, the PSC entering into the contract with the second company should be regarded as individual 1 entering into an arrangement for these purposes. As long as the individual is party to relevant arrangements it would not matter that they were implemented through the medium of either a PSC or other form of service company.

**Example 17 B.117** This example illustrates a scenario that would be **covered by the income shifting legislation**. A tax advantage is obtained through an individual giving shares to other individuals and as a result foregoing income, over which they retain power to influence, that becomes taxable in the hands of the recipients.

**B.118** Individual 1 owns all 100 £1 shares in a company. Individual 1 draws a market rate salary of £80,000 per year. In the year to 5 April 2008 the dividends paid were £60,000 after which the company had distributable reserves of £250,000. On 6 April 2008, individual 1 gives 40% of the shares to their four adult children. There are no other changes in the situation, but when dividends are declared 40% of them flow to the adult children who are chargeable at lower rates of income tax.

**B.119** The new legislation would apply in this type of situation because income is being shifted from individual 1 to their children. Individual 1 still has the power to control and influence the level of income arising from the assets given.



# CONSULTATION STAGE IMPACT ASSESSMENT

Summary: Intervention & Options		
Department /Agency: <b>HM Treasury and HM Revenue &amp; Customs</b>	Title: <b>Impact Assessment of draft legislation to address income shifting</b>	
Stage: Consultation	Version: One	Date: December 2007
Related Publications: Income shifting: a consultation on draft legislation		

**Available to view or download at:**

<http://www.hmrc.gov.uk/better-regulation/ia.htm>

**Contact for enquiries:** James Miller, 2/N2, HM Treasury

**Telephone:** 020 7270 4400

**What is the problem under consideration? Why is government intervention necessary?**

The Government believes that an individual should pay tax on income that is attributable to them. Income shifting occurs when an individual redirects part of their income to a second individual who is subject to a lower rate of tax, so that the shifted income is subject to less tax. The Government believes that there are unfair outcomes when individuals can shift their income because of personal choices that they have made. The Jones v Garnett case has highlighted the need for new legislation to provide clarity for business regarding the Government's position.

**What are the policy objectives and the intended effects?**

The new legislation should prevent individuals gaining a tax advantage from income shifting through company and partnership distributions. It is not the intention that businesses will change their remuneration structure as a result of the legislation, but rather that any tax advantage derived from non-commercial structures is negated.

The Government estimates that this would reduce the tax lost through income shifting by £200m and protect further tax loss of £350m by 2010-2011.

**What policy options have been considered? Please justify any preferred option.**

1. Do nothing.
2. Amendments to existing legislation.
3. Provide new legislation: This would prevent individuals from gaining a tax advantage through income shifting. Furthermore, it would provide clarity on the Government's position, enabling individuals who were shifting their income to plan for the future.

**When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?**

4 years (after receipt of the first self-assessment returns concerned, which will be 2010).

**Ministerial Sign-off** For consultation stage Impact Assessments:

*I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.*

Signed by the responsible Minister:

..... Date: December 2007

Summary: Analysis & Evidence					
Policy Option: 3		Description: Provide new legislation			
COSTS	<b>ANNUAL COSTS</b>		Description and scale of <b>key monetised costs</b> by 'main affected groups' - Small companies and partnerships where income shifting strategies are being followed could incur one-off transitional costs through needing additional professional advice. This may include some business reorganisation, for example removing shareholders, directors or partners.		
	<b>One-off</b> (Transition)	<b>Yrs</b>			
	£ TBC				
	<b>Average Annual Cost</b> (excluding one-off)				
	£ 0				
		<b>Total Cost (PV)</b>	£		
Other <b>key non-monetised costs</b> by 'main affected groups' - Agents will need to familiarise themselves with the new legislation to advise both businesses where income shifting occurs and businesses where remuneration patterns look similar to income shifting.					
BENEFITS	<b>ANNUAL BENEFITS</b>		Description and scale of <b>key monetised benefits</b> by 'main affected groups' - At the margin, some partnerships established to enable income shifting will revert to sole trader status. Companies set up in part to enable income shifting are unlikely to dissolve. The legislation is expected to yield revenue of £25m in 2008-09, £260m in 2009-10 and £200m annually thereafter.		
	<b>One-off</b>	<b>Yrs</b>			
	£ TBC				
	<b>Average Annual Benefit</b> (excluding one-off)				
	£ 0-200,000				
		<b>Total Benefit (PV)</b>	£		
Other <b>key non-monetised benefits</b> by 'main affected groups' - Taxpayers in general will benefit from those who formerly shifted their income bearing the tax burden applicable to their income.					
<b>Key Assumptions/Sensitivities/Risks</b>					
The overall scale of income shifting activity and the behavioural response to the legislation among small businesses is difficult to gauge accurately.					
Price Base Year 2007	Time Period Years	<b>Net Benefit Range (NPV)</b> £	<b>NET BENEFIT (NPV Best estimate)</b> £		
What is the geographic coverage of the policy/option?			UK wide		
On what date will the policy be implemented?			5 April 2008		
Which organisation(s) will enforce the policy?			HMRC		
What is the total annual cost of enforcement for these organisations?			£ Negligible		
Does enforcement comply with Hampton principles?			Yes		
Will implementation go beyond minimum EU requirements?			N/A		
What is the value of the proposed offsetting measure per year?			£ N/A		
What is the value of changes in greenhouse gas emissions?			£ N/A		
Will the proposal have a significant impact on competition?			No		
Annual cost (£-£) per organisation (excluding one-off)		Micro	Small	Medium	Large
Are any of these organisations exempt?		No	No	N/A	N/A
<b>Impact on Admin Burdens Baseline</b> (2005 Prices)			(Increase - Decrease)		
Increase of	£ 0	Decrease of	£ 0-200,000	<b>Net Impact</b>	£ 200,000 decrease

Key:

Annual costs and benefits: Constant Prices

(Net) Present Value

## Evidence Base (for summary sheets)

### Background

The Government announced in the 2007 Pre-Budget Report that it would be taking action to counteract the tax advantage gained from income shifting through partnerships and companies. The Government believes that the use of non-commercial arrangements to gain a tax advantage through income shifting creates an unfair advantage when compared with the majority of individuals who cannot or do not shift their income.

The Government is keen to provide legislation that will prevent a tax advantage being gained while ensuring that any administrative burdens are kept to a minimum. The Government believes that the legislation should provide businesses with a clear statement on the Government's position.

### Further explanation of the policy options

#### *Option 1: Do nothing*

Benefits: Keeping the status quo would provide an opportunity to continue gathering further information on the extent of income shifting.

Costs: The current losses of income tax are likely to increase, leaving those who do not shift their tax burden paying a disproportionate share of tax. Moderate estimates have been provided given the complexities of measuring the numbers of businesses involved, but it is assumed that the number of businesses that would engage in income shifting could increase following the loss of the Jones v Garnett case. This is an unacceptable risk to the Exchequer.

#### *Option 2: Amendments to existing settlements legislation*

Benefits: It is preferable to make existing legislation work where possible, as this allows a quicker response than introducing new measures and may not place new compliance costs on business.

Costs: The Government does not believe that amending the existing settlements legislation would be sufficient to prevent income shifting. Furthermore, where the legislation could be amended, it would be unclear whether it would set out the Government's position clearly for business. It is expected that a significant additional HM Revenue & Customs (HMRC) resource would be required, drawing resources from other compliance work.

#### *Option 3: New legislation specifically written to address income shifting*

Benefits: A new piece of legislation could be written to reduce potential unintended consequences. It would provide a clear statement of Government intent and specifically address current forms of income shifting.

Costs: New legislation would not necessarily have the support of existing case law or guidance. For it to be successful the legislation would have to be workable and HMRC would have to provide clear guidance on its practical applications.

### The consultation

The Government believes that it should provide a clear statement of its position in order to provide clarity and consistency for businesses. A new piece of legislation specifically written to address income shifting (option 3) would, in the Government's opinion, do this best. The Government is not consulting on the options available, but recognises that, for the legislation to be effective, it must achieve its primary objective while minimising other consequences. The Government would therefore welcome comments on how this can be achieved and, specifically, how the draft legislation and guidance within the consultation document can be improved to achieve this.

## **Predicted impacts of Option 3: Provide New Legislation**

### **Impacts on business**

#### *Revenue Yield*

The yield is based on the effect of clearer, more effective legislation, which clarifies the Government's position on income shifting.

For impact assessment purposes, yield is treated as a transfer cost rather than a cost or benefit. The yield from this measure is estimated based on assumptions of certain behaviours. The Government accepts that these assumptions may, at times, be imprecise. However, the nature of income shifting requires measurement to be made in this way.

Analysis of the data has identified 65,000 companies where income shifting is likely to be taking place. Based on the income levels and dividend strategies used, the current losses from income shifting in companies are estimated at £350 million per year. In addition it is estimated that some 20,000 two person partnerships are displaying signs of income shifting, incurring losses to the Exchequer of up to £150 million per year. The total loss to the Exchequer is estimated at around £500 million per year and would be expected to grow in the future in the absence of action. The proposals put forward will have the benefit of preventing this Exchequer loss from escalating.

The figures relating to the tax gap from income shifting necessarily consider 100% of the income concerned to be shifted income. However, the Government recognises that often this is not the case, with both individuals playing a role in the business that may warrant remuneration. The estimates of additional yield take this into account and are therefore lower than the tax gap figures. HMRC will expect all businesses to comply with the new legislation wherever it may apply. The estimated yield to the Exchequer of option 3 is £25 million in 2008-2009, £260 million in 2009-2010 and £200 million in subsequent years.

HMRC will develop a compliance strategy in line with any legislation to ensure its effectiveness. However, as with all legislation, the Government is looking to individuals to comply voluntarily without the need for interventions. To ensure this is possible, the Government would welcome comments on any improvements that could be made to the draft legislation or guidance to make this easier.

#### *Removing Inequity*

There are further benefits from eliminating the unfair advantage received by those paying levels of tax less than is applicable to their income. This is laid out in greater detail in the Competition Impact test.

#### *Administrative Burden*

A minority of partnerships that cease income shifting are likely to revert to sole trader form and therefore cease to submit partnership returns. From analysis undertaken by HMRC using the standard cost model, if 1,000 partnerships change status to become a sole trader, the administrative burden saving is estimated at £200,000 per year. However, it is not clear how many partnerships will change their status.

The Government currently does not believe that there will be a decreased administrative burden on existing companies, as it is unlikely that those companies currently income shifting will dissolve purely on the basis of the legislation. If any individuals did dissolve their companies to revert to sole trader form, it is estimated that they also would reduce their administrative burden.

#### *Transitional Costs*

All those business who are income shifting will face a one off cost in assessing the impact of the legislation. This may mean they are required to seek guidance from their accountant or financial planner and to take action in order to ensure they become compliant, or familiarise themselves

with any new legislation. Around 80 per cent of partnerships and 50 per cent of the smallest companies use an agent. The transitional cost of taxpayers seeking advice from an agent is to be confirmed.

The remainder of individuals who shift their income and do not have an agent would, however, still be subject to transitional costs. This would include familiarisation with the new legislation etc. The cost of this has not been calculated given the wide range of factors and significant difficulty in measuring them. However, the Government would welcome feedback on the expected costs in response to the consultation.

#### *Unintended Consequences:*

1. The draft legislation may encourage some individuals to exploit other methods of reducing their tax liability.
2. Individuals who genuinely pay the right levels of tax but whose businesses are structured in such a way that they may look like those who shift their income may be picked up by risk assessment in HMRC's compliance strategy.

#### **HMRC costs**

HMRC would incur additional administrative costs of enforcing compliance with the draft legislation. HMRC would need to develop guidance for compliance staff to enable them to risk assess and challenge non-compliant individuals. However, these would be relatively minor costs and, hence, are not monetised. HMRC would keep its compliance strategy under review to ensure that resources would be made available where necessary.

#### **Sectors & Groups affected**

The greatest incidence of income shifting appears to be in micro businesses and the measures would particularly affect this group. This legislation applies to all business regardless of the individuals' demographics and is designed to make the tax system fairer and more equitable.

#### **Small Firms Impact Test**

The income shifting legislation would potentially affect all business, including small business. The evidence thus far suggests that the majority of those shifting their income are from small, possibly family-run businesses. It is therefore logical to assume that the draft legislation may have a disproportionate impact on small businesses relative to large business. However, this would be due to their use of income shifting, not because of their size.

#### **Competition Impact Test**

Applying the Office for Fair Trading competition filter to the affected sectors to assess the impact of the proposed measure, it was found that an in depth competition assessment is not warranted because the estimated impacts on competition are not significant. It is, however, anticipated that taking action against those currently shifting their income would, if anything, have a favourable impact on competition, as those currently shifting their income would, following application of the legislation, pay the same levels of income tax as those in similar circumstances who have not shifted their income. Income shifting could have led to these individuals gaining an unfair advantage over those paying the correct level of tax. The proposed legislation should help remove this unfair advantage.

## Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

**Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.**

<b>Type of testing undertaken</b>	<b><i>Results in Evidence Base?</i></b>	<b><i>Results annexed?</i></b>
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	No	No
Sustainable Development	No	No
Carbon Assessment	No	No
Other Environment	No	No
Health Impact Assessment	No	No
Race Equality	No	No
Disability Equality	No	No
Gender Equality	No	No
Human Rights	No	No
Rural Proofing	No	No







ISBN 978-1-84532-365-3



9 781845 323653 >