Tax Representation

ICAEW TAX FACULTY

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INCOME SHIFTING: A CONSULTATION ON DRAFT LEGISLATION

Representations submitted on 19 February 2008 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales in response to a consultation document *Income shifting: a consultation on draft legislation* issued jointly by HMRC and HM Treasury on 6 December 2007

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INCOME SHIFTING: A CONSULTATION ON DRAFT LEGISLATION

INTRODUCTION

1. We welcome the opportunity to respond to the consultation document *Income shifting: a consultation on draft legislation* published by HM Treasury and HM Revenue & Customs (HMRC) on 6 December 2007. It can be found at www.hm-treasury.gov.uk/media/1/D/consult_income_shifting.pdf.

2. Details about the Institute of Chartered Accountants in England and Wales and the Tax Faculty are set out in Annex 1. Our Ten Tenets for a Better Tax System by which we benchmark proposals to change the tax system are summarised at Annex 2.

3. We have provided a key point summary (paras 4 to 18) together with our detailed comments (paras 19 to 141) on the proposals, the draft legislation and draft HMRC guidance. The length of our comments is inversely proportional to the mere two pages of legislation, which highlights the seriousness of the flaws it contains.

KEY POINT SUMMARY

4. In summary, income shifting as defined in the proposals (otherwise known as 'income splitting' or 'income sharing') is the process by which an individual transfers part of their income (from dividends or partnership profits) to another person who is subject to a lower rate of tax. Amounts paid out as salaries will not be affected by these rules. We believe the fundamental problem with the draft proposals is that the 'mischief' they have been aimed at is insufficiently clear thus leading to a large number of people being left in great uncertainty as to whether they are caught or not.

5. We think that these rules are too widely drafted to be workable. We deplore the growing practice of relatively brief legislation that then has to be supplemented by lengthy HMRC guidance because the primary legislation is not adequately drafted. This guidance will have no legal authority, but is merely an indication of HMRC's view of particular arrangements. It can also be changed in the future without Parliamentary approval.

6. Our usual practice when responding to consultations is to keep our comments as brief as possible. On this occasion, we think that the legislation is so poorly targeted and will be so costly for businesses to administer, that it is important to explain in detail the many defects which will prevent it from achieving its objective.

7. The requirements of the proposed legislation are impractical. The main area of contention between HMRC and taxpayers is likely to be not whether the legislation applies, but the quantum of any adjustments required. We believe it is impossible to value a person's contribution to a business with the degree of accuracy required by these proposals and still be in a position to self assess. Few, if any, taxpayers, advisers or HMRC staff will have the required skills or experience. We believe that it is unlikely HMRC will have the resources to

properly police this system and it has strong echoes of similar problems which arose around the implementation of the intermediaries ('IR35') rules.

8. We believe the compliance costs associated with this legislation have been considerably underestimated in the Consultation Impact Assessment. Compliant taxpayers are likely to feel driven to set up a considerable paper trail to justify their tax position in case of future HMRC challenge, thus leading to an administrative burden.. We also believe that the suggested possible revenue yield is likely to be much smaller than suggested. This is for a number of reasons. For example, some taxpayers will restructure to avoid the proposals; others will remain oblivious of the rule changes and HMRC will have insufficient resources to launch enquiries and others will resort to the courts which may well lead to many years of contentious legislation.

9. The example of income shifting in the consultation document at Box 1.1 is fundamentally flawed. It ignores the corporation tax payable by the company which, if included, reduces the tax saving from income shifting to a very modest amount as opposed to the thousands suggested by the illustration. The impact of NIC is also ignored. This gives an unrealistic view of what these rules really mean.

10. The policy associated with these proposals for income tax is in direct opposition to the policy which applies for capital transactions for capital gains tax and inheritance tax. In each of these taxes, transfers or gifts between spouses and civil partners are exempt, the effect being to double the level of available exemptions for couples. We believe this shows an inconsistency of approach that is hard to justify.

11. The suggestion at para B58 that each of the individuals involved should give full details in relation to another individual is a clear breach of taxpayer confidentiality.

12. We note that it is intended that the treatment of class 4 national insurance contributions will follow the tax treatment, but that the draft NIC legislation has yet to be published. We do not think it acceptable to rush through legislation for income tax purposes where the NIC consequences applying to the same transactions are uncertain.

13. We are concerned that the subjective nature of the 'reasonable to assume' anti-avoidance test in the proposed s 681B could lead to genuine injustices, and would urge the adoption of an actual anti-avoidance test, as is more usual in this kind of legislation.

14. There is no time limit for reviewing a link between arrangements and income shifted as a result. It could therefore be possible for HMRC to look back over many years, to income-sharing arrangements set up far in the past and argue that the legislation applies. This is against the legitimate expectation of the taxpayer.

15. The HMRC guidance implies that businesses which have 'a combination of managing investments and carrying on a trade' triggers the tighter definition of 'relevant arrangements' for investment businesses. It appears that even a

relatively small amount of investment business can contaminate the rest of the profits and thus potentially bring this legislation into play.

16. There has been no consideration of how income raised by these proposals will be reviewed. It is suggested that there are 20,000 partnerships and 65,000 companies affected. If so, 40,000 individual partners and 130,000 shareholders (assuming two person businesses) would be making adjustments to their income and the only way of highlighting the amounts would be by looking at the written note in the white space on their tax returns. This would need to be reviewed manually. This would be an extraordinarily onerous task for HMRC, which would be extremely costly.

17. We recommend that if these rules are to be implemented, it is essential that they are deferred until 6 April 2009 to allow time for considered consultation with business and the tax profession on the practical difficulties of implementation and clearer targeting for taxpayers. If Ministers are not minded to do this, we would suggest that smaller businesses are exempted from the operation of the rules and that this area is then revisited in light of the on-going small business review.

18. The consultation launched in December 2004, *Small Companies, the self-employed and the tax system*, identified many of the problems with the way that small businesses are taxed under the current system. Discussions on how best to tax profits from small businesses need to be revived so that taxation in this area can be simplified and the associated costs reduced. We would suggest the long-term solution is to re-energise this review to deal with all interlinking areas of small business taxation rather than 'sticking plaster' rules such as 'income shifting' which we believe will create more problems than it solves.

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GENERAL COMMENTS

Time for consultation and implementation

19. The proposals were announced in draft on 6 December 2007. Although the consultation period runs to 28 February 2008, this is only a few weeks before the legislation is due to come into effect. This allows very little time to explain the final version of the rules to clients and advise them of the changes and any additional record keeping or systems that need to be put in place. Meanwhile, the worry and speculation about what the rules might mean for different businesses detracts from what small businesses should be doing, which is actually running those businesses.

20. We urge the Government to defer any change for at least a year to allow time for more thorough consideration of how these rules might be better targeted and to allow businesses and HMRC to make any changes to their systems in a more considered manner. Alternatively we would welcome removing smaller businesses from the ambit of these rules and then for the whole area to be reconsidered as part of a re-energised review of small business taxation.

Policy issues

21. We do not believe the policy behind income shifting has been properly publically articulated. We have been told that the new rules are not just a direct reversal of the House of Lords decision in *Jones v Garnett* and the breadth of the draft legislation is certainly much wider than that case. However, the real 'mischief' being targeted is not clear and hence the reality that many taxpayers will fear that they are caught by the new proposals when they may well not be. We believe the draft legislation should be far clearer in its intent and clearly exclude those it does not seek to catch.

22. In addition the policy associated with these proposals for income tax is in direct opposition to the policy which applies for capital transactions like those in the capital gains tax and inheritance tax regimes. In each of these taxes, transfers or gifts between spouses and civil partners are exempt, the effect being to double the level of available exemptions for couples.

23. Thirteen other OECD countries (see Annex 3) allow income splitting for any form of income and indeed consider it quite normal. These countries include the US, France and Germany. Canada has recently joined this list for pensioners and is considering extending its rules to other taxpayers. It is therefore surprising that the UK Government considers that arranging the ownership of a family business between family members, for example, is unacceptable tax avoidance.

Lack of certainty

24. We are disappointed that the current practice of brief law accompanied by lengthy HMRC guidance has once again being adopted. It is vital that the primary legislation is properly drafted and we do not have to rely on so-called 'tertiary legislation' to understand the rules. HMRC guidance has no place in law and so cannot be relied upon in Court. It also can be changed without Parliamentary scrutiny.

25. It seems that the new rules will apply to accumulated profits from earlier years which will make the effect of this law retrospective. The temptation will be for businesses to pay out accumulated profits before 6 April 2008, but this is contrary to the Government's stated policy of wanting businesses to retain profits for growth and expansion.

Time limits

26. In addition to the inherent uncertainties of the proposals, paragraph B18 of the consultation document states that there is no time limit for reviewing when arrangements may have been made and when shifted income is received. The guidance makes clear that this means that an 'arrangement' may cover more than one tax year, such as where, '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'.

27. This lack of a time limit makes the legislation particularly onerous. It is possible for HMRC to look back over many years, to income-sharing arrangements set up far in the past and argue that the legislation applies. The concern for taxpayers will be whether there legitimate and reasonable expectations of the tax implications of their transactions are going to be over-ridden by new and unexpected rules.

Loss relief

28. Insufficient consideration has been given to losses. What follows is an example of some of the problems. Note that a company can pay a dividend whilst suffering a loss, the dividend being paid from reserves.

29. There are no provisions for transferring losses. If both the husband and wife in a 50:50 partnership make a loss of £20,000 one year and a profit of £30,000 the next, they will expect to offset the loss against the profit. The legislation may require that all the profits are attributed to individual 1, leaving individual 2 with no profits to offset his or her losses against. This could fairly easily be dealt with by a provision such that where profits are transferred by a party, any losses can also be transferred up to the same amount at individual 2's option. There could be a time limit of one or two years after any profits are assessed on individual 1 to simplify the proposal.

National insurance

30. Paragraph 1.15 states: '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.'

31. It is not completely clear what this means. Taken literally there would be a transfer of income for class 4 purposes only where income shifting had caused a class 4 liability to arise. This is far too narrow. Any income transferred for Income Tax purposes should also to be transferred for class 4. Failure to do so would cause huge injustice in a partnership, as where the income tax rate goes up from 20% to 40% the class 4 rate goes down from 8% to 1%. Failure to extend this would leave individual 1 paying income tax at 40% and individual 2 paying

national insurance at 8% - a very oppressive regime for a couple who might only be earning £45,000 a year.

32. This could become very messy where losses are concerned. There are circumstances where someone could have losses brought forward for national insurance purposes but not for income tax (as they could have been set against unearned income).

33. It is also very important that the provisions for national insurance take effect at the same time as those for income tax, otherwise there will be a period when partners could be paying tax at 48% as described above. Regrettably there is no sign of this happening. With managed service companies (MSCs) the national insurance changes came in several months later. With income shifting (unlike MSCs) we are dealing with class 4 national insurance, which is assessed on an annual basis, so it would have to be introduced with effect from either 6 April 2008 or 6 April 2009. If, as is to be hoped, the former, then HMRC need to announce this. If the latter then these provisions should be deferred to 6 April 2009

34. There should also be a provision so that if individual 1 is taxed on shifted income which is below the threshold for class 2 national insurance, then nothing is due.

Quantification of the shifted income

Valuations

35. The proposals suggest that merely keeping adequate records will enable accurate valuation of a person's contribution to a business.

36. We disagree with this supposition. Even if the records are kept, arriving at a fair allocation of profits will require a valuation to be placed on individual 2's work, and very often individual 1's as well. There are no accepted standards for such valuations. It has never previously been a requirement for the accountant or HMRC official to do more than verify that the tax deduction for the salaries paid satisfies the wholly and exclusively requirements of the Taxes Acts.

37. Some types of position, such as owner-director and what might be called the owner-director's 'spouse-cum-factotum', do not exist on the open market and it seems unlikely that a local Job Centre would be able to supply rates to match these descriptions. It might be able to produce something similar, for example, for a personal assistant (individual 2), but for individual 1, the expertise of private sector employment agencies would be needed. These would charge for their services and would be likely to produce wild fluctuations in their attempts to provide valuations. In the case of individual 2, one should be able to justify adding on quite a substantial factor to take account of the fact that the spouse-cum-factotum is extremely reliable and knows the principal's mind instinctively; also that he or she is in no danger of leaving the company and is available during unsocial hours.

38. A requirement for such valuations will create a need for more record keeping as both the accountancy profession and HMRC seek to acquire the new expertise needed to place a value on these services.

39. At present there are only two circumstances where one is called upon to put a value on these services for tax purposes, neither of which is analogous to this new requirement.

40. The first is where a spouse's salary must be justified to qualify for an income tax or corporation tax deduction. In reality HMRC hardly ever challenges this and where it does, the amounts of money involved are generally very small. A wife claiming a salary of the personal allowance (£5,225) might save her husband tax at 40% of this, i.e. £2,090, but this is only likely to arise as an issue where she is doing no work at all. If she is doing some work a salary of more than £5,225 can almost always be justified and she would usually be taken into partnership, thus avoiding the need for this valuation.

41. The second is where a goodwill valuation is required. If a company director is only taking a tiny salary out of the company, this will increase its profits and artificially increase the goodwill. When such a business is sold it is common practice to make an adjustment to reflect the commercial salary that the owner-director might be drawing were he not the owner. However, this is only one of the factors which are taken into account when valuing the goodwill and an error estimating that salary is not likely to make a huge difference to the goodwill valuation overall unless that error is itself very large.

42. By contrast, in the proposed legislation, the valuation of the two parties' services is critical to the calculation of the transfer of income. Indeed, it is the need to put a value on the income shifted rather than the principle of the matter that is likely to cause HMRC, advisers and businesses alike most problems.

43. It is very difficult to value a person's ideas. One particular individual may spend minimal time working in a business, perhaps only a few hours a week. That person may however generate all of the sales leads and therefore be arguably worth in excess of his partner or co-shareholder who works 60 hours a week supplying the product or service.

44. The examples of valuing a partner's contribution within a partnership structure make no allowance for risk. The document seems to confuse 'risk' and 'capital' – while investing capital is a risk there are other risks such as the risk of the business going bust because of a negligence claim and the assets of the partners being taken. Even though a partner may make no contribution in work terms to the business, the risk involved is one of joint and several liability. If the business goes wrong, a partner could lose everything. There must be some recompense for risk otherwise people will never go into business.

45. In paragraph 1.6, the paper states:" 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." We do not see why this is necessarily so. This reasoning does not apply to large companies so why should it apply to small ones? What then is the cut-off point for the size of company where a passive investor is permitted?

46. Bearing in mind the wide range of possible answers for the value of individual 1's services, and the unique circumstances in which individual 2 often works, this area will be a perfect target for investigation work, the costs of which are not reflected in the Consultation Stage Impact Assessment.

47. With an enquiry, there is always a point at which the costs of arguing a point will out weigh the tax at stake. The temptation to settle will be great just to make the problem 'go away'. The uncertainties of this legislation will make this a particular problem for small businesses.

48. The illustrations of how to value income which has been shifted fail to recognise the value of capital and goodwill, if any, which may also be transferred. HMRC previous Guide to the Settlements Legislation for Small Business Advisers included such recognition.

49. We fully appreciate that a transfer of shares must not provide wholly or substantially a right to income and that for a legitimate transfer there must be a right to capital as well. This is the whole basis of independent taxation of husband and wife. Without some recognition for the transfer of capital this principle would be severely compromised.

50. Where goodwill is not personal to an individual shareholder, i.e. it is inherent or free (including both adherent and separable) goodwill, it is undoubtedly part of the value transferred and a notional return should be recognised.

51. An example of how this may be applied is set out below:

Total value of business, including goodwill	£150,000
Value applicable to shareholding – 50%	£75,000
Typical return on investment – say 10%	£7,500
Annual rate for work carried out	£20,000
Hours worked per week - 10	
Full time weekly hours - 40	
10 / 40 of £20,000	£5,000
Entitlement (£7,500 + £5,000)	**£12,500**

The excess over this entitlement would be subject to the income shifting rules

Tax credits

52. Does income that has been shifted for tax purposes also get shifted for tax credits purposes? Suppose this time there is a brother and sister partnership, where the sister is taking a few years (more than merely maternity leave) not working in the business while she cares for her young children. The partnership earns £50,000 one year and as there is no significant capital involved the sister's share is transferred to the brother under the income shifting provisions.

53. Now suppose that these siblings each have spouses both of which earn £10,000 from other sources. Can the sister say that her family has only earned £10,000 that year and so is entitled to tax credits and other income related benefits?

54. It depends. If the business is a partnership, she can. ‘Trading income’ for tax credits purposes is her ‘taxable profit for the year arising from [her] share of the partnership’s trading or professional income’ (Tax Credits (Definition and Calculation of Income) Regulations 2002, reg. 6.), in this instance nil. Likewise the brother, whose family are deemed to have earned £60,000 (although they have not actually received any money) will not be entitled to much, if any, tax credit at all.

55. Contrast this with dividend income, where regulation 10 defines the income as ‘dividends and other distributions of a company resident in the United Kingdom and any tax credit associated with that payment’; i.e. the dividends actually received. It appears that no adjustment is made here.

56. The only thing that can be said with confidence is that neither the affected taxpayers nor the HMRC officers administering tax credits will be able to follow this.

57. The system must be aligned, and aligned around income actually received, as that defines where the tax credits will be needed.

The anti-avoidance wording

58. We are very concerned about clause 681E, subsection 1, which deems arrangements to be ‘relevant arrangements’ (and so subject to the draft legislation) where ‘(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’. The words ‘reasonable to draw the conclusion’ will very often leave it to an HMRC inspector to have the last word as to whether tax is being avoided, without any effective right of appeal.

59. This can be illustrated by reference to example 17 in the consultation document. This concerns a proprietor of a company with sizeable reserves (£250,000) who draws what is agreed to be a market salary. He passes on 40% of the company to his adult children in a genuine alienation of capital. According to the consultation document the children’s dividends are still caught by the legislation because he still has power to control and influence the level of dividend given to his children.

60. Tax avoidance might be a reason for passing on the shares, so that conclusion is – *prima facie* at least – a reasonable one to draw. In reality, though there are likely to be quite a number of other reasons at play. This may be done as part of succession planning, not only if some of the children are involved in the business, but also if there were plans to involve them in the future – possibly even to encourage them to participate. It might be a genuine passing on of capital from an older person who no longer needs the income, to the younger generation who do – a perfectly natural thing in the eyes of most people, and one that just happens to be done with shares in a family company because those are his main assets. In those circumstances tax avoidance is likely to have been far from this

unfortunate character's mind. Indeed, it is a transaction on which he may well not have consulted his professional advisers at all.

61. It can thus be seen that, whilst it might be reasonable to draw the conclusion that tax avoidance is a main reason for passing on the shares, it would be just as reasonable to draw the opposite conclusion, and we are concerned that HMRC, by producing this example, might be displaying evidence of a mindset that will not always be warranted by the actual facts.

62. This wording – that it would be 'reasonable to assume' that income tax avoidance is a motive – does appear in one other place in income tax law, but much more common is an actual avoidance test, for example in s 685 of the Income Tax Act 2007 ('ITA'). In order for the preceding section not to apply, the person concerned has to meet the condition that 'enabling income tax advantages to be obtained is not the main object or one of the main objects of the transaction or, as the case may be, any of the transactions'. This means that the tax avoidance purpose must be an objective fact, and that the inspector's opinion on the matter can be overturned by the Commissioners. Similar wording or similar principles can be found in ss 81, 597, 608, 739, 773, 779, 782 and 904 ITA, ss 2331B and 731 and schedule 28AA of the Income and Corporation Taxes Act 1988.

63. Indeed, when reading anti-avoidance legislation it is generally clear even from a cursory glance that it is designed to counter devices that have been conjured up by highly-paid advisers enabling the rich to avoid large sums of tax. The very opposite is the case here: many people affected by this legislation will have no advisers at all, or unqualified ones; most of them will not be wealthy; and the maximum amount of tax and NI that can be avoided by a couple is £8,650 a year (at 2007/08 rates).

64. We believe that it would be quite wrong for HMRC inspectors to have the last word on such a subjective matter given that many of them have no natural understanding of how family businesses work and the subjective nature of the judgments required. We remind the reader also that at the present time few if any HMRC inspectors have the requisite experience to judge the quantity of income shifted. There must be an effective right of appeal otherwise genuine injustice of a capricious nature is likely to result. We strongly urge HMRC to adopt wording similar to that in s 685 ITA and to abandon the 'reasonable to assume' test.

DETAILED COMMENTS

Administrative cost burden

Record keeping

Para B45 'The income shifting legislation does not mean that businesses will have to maintain any additional records.'

65. It is hard to reconcile this assertion with the statement four paragraphs later at para B49 that '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 amount of work done', or with that at para B63 which says that in assessing the amount of income shifted HMRC might ask for relevant documents,

such as ‘contracts of employment, time sheets, board minutes, any research done on the market rates of pay for the duties undertaken by individual 2’.

66. If HMRC were to state that it is prepared to accept whatever taxpayers say on this subject, there will indeed be no need for any record-keeping, but this seems unlikely and for it to do so would be an invitation to dishonesty. Failing that, any disputes as to how much work individual 2 (the supporting person, e.g. the wife who is a part-time administrator) has done could only be resolved by keeping records of the hours worked. This will require a major culture change in most businesses and will be very widely resented. To require timesheets would also be to impose a further administrative burden on businesses.

67. The suggestion has been made in the consultation document that the assessment needs to be made on an annual basis, which will also give rise to substantial costs.

68. In order to generate the income expected by the Treasury, HMRC will have to open enquiries not only into the principle of the matter, but into the quantum as well in a large number of cases in which they suspect income shifting to be occurring. According to the consultation document there is evidence of income shifting taking place in 85,000 businesses. Many of these will be unrepresented taxpayers and will be unaware of the new rules and many others will seek to justify a value for individual 2’s input which is different from HMRC’s.

69. Based on a bare minimum of a half-day for each enquiry, this would require a minimum of 200 extra inspectors to have any effect. This seems an unlikely possibility in a world of limited resources. It also is unlikely that the additional costs will reap the expected benefits.

70. The consequence of any “errors” will result in substantial penalties under the new penalty regime.

71. We recommend at least introducing a de minimis limit to this legislation. Because the rate of return for respective husband and wife contributions is so judgmental, there is the potential for argument over small amounts. Under the current proposals there is nothing to prevent HMRC in an enquiry from seeking to reallocate £10, or even £1.

72. We suggest that a deminimis of £5,000 of income, which would save tax of £2,000, would be in keeping with the new-style HMRC which is focusing investigations using a risk assessed approach. This would mean that where the difference between the income shifted (which caused a tax advantage) and the amount which HMRC thinks was correct was less than £5k they would leave it alone.

73. An alternative approach would be to focus the de minimis on the size of business which might be caught by these rules. An exemption based on turnover, for example, would mean that the smallest businesses would not even need to incur the administration costs of considering the legislation. We believe this would have a strong read-across to other similar legislation. Transfer pricing rules, for example, require a quantification of an arm's length transaction, much as being requested for income shifting. Transfer pricing is so onerous that smaller

businesses are excluded from its remit. We believe a similar logic could be applied in the case of income shifting.

Consultation stage impact assessment

74. The assumptions made in this impact assessment are totally unrealistic.

75. Early indications from a recent survey of Tax Faculty members suggested that most accountants with SME businesses as clients expected their own costs in reviewing client files to identify problem cases would exceed £500 per client.

76. If a business changes its status from a partnership to a sole trader or changes the way that its shares are owned, there are considerable compliance costs. These have been ignored in these estimates.

77. It will be impossible to measure the impact of these proposals on tax yield since there is no mechanism for collecting this data electronically through tax returns. The comment at para B57 requiring an explanation in the white space box of a tax return, suggests that this information can be captured and analysed in this way. This is not the case.

78. HMRC enforcement costs will be considerable. The suggested scale of the enquiry programme which will be needed would be prohibitive. There has also been no consideration of the upfront training costs nor of the costs of producing guidance.

79. There has been no consideration of how income raised by these proposals will be reviewed. It is suggested that there are 20,000 partnerships and 65,000 companies affected. If so, 40,000 individual partners and 130,000 shareholders (assuming two person businesses) would be making adjustments to their income and the only way of highlighting the amounts would be by looking at the written note in the white space on their tax returns. This would need to be reviewed manually. An extraordinarily onerous task for HMRC, which would be extremely costly.

Retrospective legislation

80. This legislation is retrospective in that it affects accumulated profits brought forward at 6 April 2008.

81. Specifically, the examples also assume that all the profits are distributed each year; this is not often the case in companies. The complexities of linking work to distributions thus becomes very complex. Is one looking at the work done when the profits (which have formed part of the undistributed reserves) were made; or the work done when the dividend was paid? It is unclear.

82. HMRC guidance paras B13 and B18.

- B13: " … even where the shifted income is derived from an earlier period."
- B18: "… the legislation does not provide any time limit. For example, individual 1 might be a party to arrangements in year 1 but individual 2 does not receive the shifted income until the next or a later year."

83. This has generated considerable concern. Just how far back are clients supposed to trace their 'contribution' to the business?

84. Consider a husband and wife company which has been running for 20 years. Mr A and Mrs A generate different levels of profit for the company in different periods according to the market demand for their different skills and their other family/ training commitments etc. The profits are generally retained in the business and paid out as required in later years. Do Mr and Mrs A have to look at the profits they generated in years 1 – 20 to determine how to distribute dividends in year 21 and beyond?

85. Is it reasonable to ask clients to look back 20 or 30 years or more to decide if arrangements made then were made on a commercial basis or not?

86. How will the legislation operate where the individuals were not connected in say years 1 to 5 but then become a couple, so are connected from years 6 to 20? Does the legislation only look at the connection at the point where individual 2 receives the income, not at the point when the income was generated by the business?

Modern business structures

87. Many family companies have shareholdings that are not necessarily representative of any particular individual's involvement, ability or contribution, but which are a reflection of ownership. Particularly, where shares are held by different generations, the younger generation initially contribute possibly less, whereas over time they will expect to contribute more with the older generations taking a reduced role. It will be extremely complicated to try and reflect these changes and assess the commercial salary/worth of each.

88. In addition, if say there are four children who each have shares in a company and one of them has some form of disability, that may prevent that person from contributing as much as the other children. It would seem somewhat inappropriate that we have to highlight this problem to the individuals and discuss it in great detail to assess worth/contribution.

89. In some professional partnerships which have connected persons within them, it is accepted practice to continue to allocate profits to older or more senior partners whose contribution is no longer as commercially valuable as some of the other partners. Sometimes this is seen as a form of pension for past years service. Sometimes it is simply impossible to deal with the diplomatic minefield of downgrading the value of their respective contribution. We should like confirmation that the income shifting legislation would not apply in such cases, although this is not clear from the definition of 'relevant arrangements' in s681E.

90. Contributions by different individuals may vary over time because of personal or family problems which affect their performance. In addition, conditions such as stress or depression can adversely affect a person's performance.

91. To apply the income shifting law accurately, accountants would need to discuss these very sensitive issues with clients in order to assess their respective performance in any year.

92. As with many such subjective tax laws, an accountant who is behaving professionally and applying the law properly will spend more time- which the clients will be reluctant to pay for- and risk alienating clients, than a less conscientious accountant.

93. We would like confirmation that the rules as drafted do not apply where a partnership admits a corporate entity irrespective of who controls that company.

Other practical issues

One person gets the money, another one pays the tax.

94. An important point to note is that the extra tax can be payable by someone who has not actually received the income. Whilst this may not be a problem for a couple who are still living together in harmony, it will be where they have since separated.

95. Consider a partnership with a 30 April year end. Profits earned in May 2008 will be taxed in the year 2009/10 and declared on the 2010 Tax Return. Tax will be payable in January and July 2010, with the balance due in January 2011. For this return, the enquiry window could be open to January 2012 at the latest, with the enquiry concluding several months later still. This gives over four years for things to go wrong and could lead to genuine injustice. It is conceivable that individual 1 will be pursued for tax on shifted income which he or she does not have access to long after a separation agreement has been finalised.

96. Taken with the previous point, valuation problems will be relevant here too. When a couple separate, they will generally have different advisers. It is likely that they will not agree on the amount of income transferred. If they disagree, their evidence for the respective contributions of the couple to the business is likely to be different too – divorce cases are notorious for such arguments. They may even file tax returns on different bases. For example, with profits of £80,000 and a 50:50 split, individual 1 files a return for £40,000 on the basis that there is no tax avoided because individual 2 has made a sufficient contribution to get into higher rate, whereas individual 2 thinks that she has not made so much of a contribution and neatly files a return showing only £15,000 of income. In this case HMRC will actually lose compared with the current basis unless they open an inquiry into both returns.

97. Individual 1 and individual 2 may have different accountants and different tax offices. Each will have their own view on the value of income shifted, if any. Settling disputes will be costly and may also become tangled in the matrimonial law around the division of shared-ownership assets.

98. The consultation document states at para B62: 'Each individual is responsible for completing their [sic] 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.' Such an enquiry would use considerable resources for all involved.

Property businesses

99. The legislation only applies to a 'business' in law: without that it cannot be a partnership (see page 1030 of the HMRC Property Income Manual for further details). There is a considerable confusion in practice in relation to how big a property business must be to constitute a 'business'. This will depend on the facts and in particular the amount of work involved. In *Rashid v Garcia* [2002] (SPC 348) the claimant was found not to be in business even though he let four residential properties requiring varying amounts of activity. He was described by the commissioner as being 'near the borderline'. In *Griffiths v Jackson* [1983] STC 184, by contrast, a partnership letting out 11 furnished flats was held to be in business. Common sense would indicate that there would need to be rather more than this in the way of unfurnished long-term lets; by contrast, a single labour intensive furnished holiday let could be sufficient to be a business. It is absolutely essential that there is a clearance process in this area, or at least some guidance from HMRC as to what they will accept as not being a partnership.

Investment businesses

100. The definition of 'genuine commercial arrangements' has an added limb where the business is an investment business (this could, but does not necessarily, mean a property investment business, and does include a business carried on by a company). The 'person by whom it [the making and/or managing of investments] is done' – i.e. the manager – and the 'person for whom it is done' – i.e. the owner – must be persons who are not connected with each other and who are dealing at arm's length. This means that even where the arrangements are made on commercial terms (i.e. with a market salary for the manager) one cannot manage investments for one's spouse or children without falling foul of the legislation, where the amount of work is such as to constitute a business.

101. In these circumstances the definition of 'forgoing income' becomes crucial. Suppose in this instance a widow has inherited a portfolio of a dozen houses, which are all rented out at £7,000 a year, giving her an income of £84,000. This would probably constitute a business. Now suppose that she sells a one-third share to her son at valuation, and insists on retaining a 'salary' of £6,000 a year for managing the properties. He has no earnings because he has brought forward losses in his business. This looks like a genuine commercial arrangement with a genuine alienation of real capital, but it is caught nevertheless – the manager (mother) and owner (son) are connected parties. The mother has forgone income under s 681F(a) as she would, apart from the 'relevant arrangements', be entitled to receive the income but does not do so. The 'relevant arrangements' include the sale of property to the son.

102. Contrast this with the case where she had sold them to her son before the draft legislation was announced. Having made a sale without the benefit of knowing about the forthcoming legislation it would not have been reasonable to draw the conclusion that the purpose, or one of the main purposes, of the arrangement was the avoidance or reduction of income tax. It would therefore not be caught.

Managing investments contaminating other trade activities

103. The guidance states (para B21) that the higher hurdle set by s681E(4) applies not only to investment businesses as such, but also to businesses which have 'a combination of managing investments and carrying on a trade'. This statement

does not reflect the legislation, and thus may not be correct. But if it is the case, this broader definition may well apply to most small businesses which have cash or other investments.

104. If a combination of trading and investment business triggers this tighter definition of ‘relevant arrangements’, there is no mechanism under which the legislation applies only to the profits arising from management of these investments. Thus it appears that even a relatively small amount of investment business can contaminate the rest of the profits, and thus potentially bring this legislation into play.

Businesses with low profits or losses

105. The consultation document gives a number of examples of how the legislation works and where is does not, but one cannot help noticing that all these examples presuppose a business that takes off and gives a good return in a very short time. In the real world things are often quite different: many people are forced into setting up businesses when made redundant or else where they have to make significant investments in time and materials before making an impact on the marketplace . The returns in the early years are often quite meagre.

106. Consider an example that is not in the consultation document. H and W set up a company using £50,000 of W’s money. H works full-time and is effectively in charge, but W gives a good deal of part-time support and contributes to the management of the enterprise as well as doing clerical work. In the first year the business makes a loss of £5,000, in the second it generates £15,000, in the third £50,000 and in the fourth £80,000, with good prospects to come.

107. If H were to do this on his own, he would not be able in the early years to pay a commercial salary for someone to do what W does. Many people would take the view that, in view of her capital contribution, it would be quite fair for H and W to split their earnings evenly.

108. The problem here is that there is no such thing as a ‘genuine commercial arrangement’ for H and W’s involvement in this business. No bank would lend the full £50,000 on such a projected cash flow and venture capitalists would not deal in such a small sum. H can legitimately say that he would not start the business at all without both W’s capital and her involvement. Likewise W can legitimately say that she would not invest money in the business unless H was running it.

109. Suppose that in years 1 and 2 they live off savings and salaries of £5,000 each, and otherwise draw no money out of the company; in year 3 a dividend of £20,000 is paid (£10,000 to each) and in year 4 one of £50,000 (£25,000 each). This makes £70,000 of dividends, with a possibility of higher rate avoidance in year 4. Whose money is the £70,000 under these principles? It seems pretty clear from the principles above that both parties could legitimately lay claim to the entire £70,000. A commercial salary for H could easily be £40,000 a year, whereas W could expect a commercial return of about 25% on her money as well as a salary, given the possibility of failure of the business – probably about £30,000 a year in total.

110. How does the proposed legislation deal with this? At first appearance the equal income-splitting arrangement is not a ‘relevant arrangement’, on the basis that

the avoidance or reduction of tax was not one of its purposes. This does, though, depend on how far ahead one looks. Once the initial early years are over and W's money is repaid, it will clearly be the case that H should be taking a lot more out of the business than W. In the long run this will lead to income shifting, but not in the short or medium term.

111. This then leads one to take a closer look at what the arrangements actually are. Come year 8, when W's involvement is rather more part-time than heretofore and she has her money back, can HMRC say that by continuing with this arrangement H is diverting income to W? At this stage he could simply wind up the company and start again: it would require a certain amount of capital but by now he has a good income and a track record – he could borrow the money from the bank this time. (Half the capital would obviously go to W, and she would get some sort of return on this but not such a high one.) As against this, W would be quite entitled to say that her presence and her capital had been absolutely vital at the start-up of the venture and it would not have got off the ground without her. She was quite entitled to insist on a share of 50% in the circumstances and is entitled to her reward now that it is successful. It could be argued that 'arrangements' are only a single arrangement made at the outset and not altered since, and it was not one that had tax reduction or avoidance as its main purpose.

Taxpayer confidentiality

112. Example 4 on page 25 highlights a potential problem with taxpayer confidentiality. HMRC claims that this is outside the draft legislation because no tax advantage is obtained. This is correct if individual 1 has no other income. If he does, the income shifting rules may cause him to become a higher rate taxpayer and so create the problem which will need to be declared. He will need to tell individual 2, which will involve disclosing that he has another source of income. Although he does not have to be any more specific about this it will constitute an enforced breach of confidentiality.

113. A further example of this could easily arise in a partnership, where one party has paid off a loan, thus increasing his income. This might well push the income shifted to a level where tax might be avoided. Details of borrowing arrangements are matters that people expect to keep confidential, and we do not believe that forced disclosure of them is warranted.

114. It is also hard to see how taxpayer confidentiality is going to be maintained in cases where there is a disagreement between the two parties. In a case such as a partnership where the amounts actually declared do not add up to the total income, HMRC may have to challenge both sets of figures. In the event of an appeal by one of the taxpayers, can HMRC use information gleaned from one party in dealing with the other's case?

Comments on examples given in the guidance

Box 1.1 para 1.9

115. The headline examples in para 1.9, Box 1.1 which are used to build the case for these proposals are misleading. The calculations have omitted the corporation tax which a company must pay and in order to make meaningful comparisons, the national insurance payable by an individual or partnership

must also be taken into account. The tax gap of £9,375 shown in the example is totally misleading. The correct figure for comparing the tax payable by a sole trader as opposed to a limited company is only £3,110.

116. Based on a business which makes a taxable profit of £60,000, the correct comparisons should be as follows (see Annex 4 for calculations):

Business set up as a company

	Nina as 100% shareholder	Nina and Charles owning 50% each (combined charge)
Corporation tax	12,000	12,000
Income tax	3,039	
Total tax charged	15,039	12,000

Tax saving resulting from joint ownership of the company is £3,039

Business remains unincorporated

	Nina as sole trader	Nina and Charles as equal partners (combined charge)
Income tax charge on profits	15,414	10,366
Class 2 NIC	114	228
Class 4 NIC	2,621	3,964
Total tax charged	18,149	14,558

Tax saving resulting from partnership is £3,591

Box B.4 Example D, scenario 4

117. The example given in Box B.4 Example D, scenario 4, quotes a normal unsecured loan rate of 22%. This is totally unrealistic. It is highly unlikely that any bank would offer such a loan at all without security, let alone at 22%.

Example 1, para B69:

118. The supposition that income shifting has not taken place is not correct. This illustrates that even in such an apparently straightforward simple case, these proposed rules will require the taxpayer and his adviser to undertake additional work.

119. These two individuals would have to build evidence to show that the work that each did ranked equally. That would not be easy. Even where both were carrying out exactly the same kind of work, records of hours worked would have to be created and retained, as well as proof that the value of the work in each case was the same. Suppose Mr A operates such a company with his wife. Mr A negotiates to work for a client at an effective fee of £200 per hour; Mrs A in dealing with another client manages to get £300.

120. Mr B may work 35 hours a week and Mrs B works 70 hours. She will be shifting income to Mr B even though both work ‘full-time’. Perhaps there should be an exemption where both individuals work full-time?

Example 5, para B81

121. If business profits suddenly doubled, the legislation would then deem the arrangement to be uncommercial, yet this is presumably the intention of any person going into business whether as an active partner or a passive investor.

Example 17, para B119

122. Parents are entitled to transfer capital to adult children and this is taxed (subject to exemptions and reliefs) under IHT and CGT legislation. The capital value of the shares should take into account the profitability of the company and its dividend policy. If Father still draws a market rate salary then he has foregone nothing by way of reward for work done and the dividends must be a return on capital so income shifting cannot apply.

123. We disagree with the HMRC view that this should be covered by the income shifting legislation. Indeed, if HMRC applies this reasoning then generation to generation transfers of family businesses will be restricted substantially.

124. If a company is legitimately run by a husband and wife and as a couple they decide to have children, more often than not the wife will work reduced hours in the business for a period of time. The implied requirement of these regulations is that we should then allocate a reduced profit share to this non-working spouse, either as a matter of fact, or at least for tax purposes through applying the income shifting legislation.

125. Employment rights allow a period of paid maternity or paternity leave. Para B110 states that the legislation would not apply where the time off is for maternity or sick leave. Whilst we support this principle, it introduces yet another subjective decision into the self assessment process since what is an acceptable period of absence for one business might be quite different for another.

Comments on the draft legislation

126. The proposed guidance includes more conditions and tests than the draft legislation itself.

127. The definition of connected parties is understood to be that in s 993, ITA 2007, as this applies when no other definition is specified (s 1021, ITA 2007). This is a very broad definition, and includes trustees, partners, associated companies, 'relatives', and 'the spouse or civil partner of a relative of [the individual's] spouse or civil partner'.

128. 'Genuine commercial arrangements' seems very difficult to define.

129. It would be clearer if the conditions A, B and C in cl 681E, could be relabelled E, F and G to avoid confusion with A, B, C and D in cl 681B.

130. cl. 681E Meaning of relevant arrangements

(1) (b) We think the clause could be simplified by removing the words '*it would be reasonable to draw the conclusion, from all the circumstances of the case, that the purpose or*'

(2)This states that conditions A and B and C must **all** be met for the arrangements to be genuine commercial arrangements.

If so then condition B requires the persons not to be connected where the business is an investment business, but that otherwise the individuals can be connected?

(5) The double negatives make this clause difficult to follow.
"… the arrangements are not-
on terms other than those that would have been made between persons not connected with each other dealing at arm's length."

We presume that this means the terms are on a par with the terms used by unconnected people dealing at arms length.

Why is the double negative needed?

Connected persons

131. Nowhere does it say that individuals 1 and 2 have to be connected with each other for the legislation to apply. The persons in condition B of cl. 681E do not appear to have to be the same as individuals 1 and 2.

132. So if individuals 1 and 2 are connected, but act according to terms that unconnected persons would agree to (condition C in cl.681E), and conditions A and B of that clause are also met then surely the legislation cannot apply.

cl 681F(a) 'entitled to receive income'

133. It is not clear what is meant by the term in (a) " …entitled to receive the income but does not receive it".

134. Surely a shareholder is not entitled to receive income from a company until the dividends are proposed and voted on. If the dividends have been proposed and voted, but not paid to individual 1 because a dividend waiver is used to boost the income for individual 2 then the legislation applies. However, where profits are left in the company and no dividends are proposed, no shareholder is entitled to receive the income. The shareholder might have a right to assets on a winding up - but assets are not 'income'.

135. Perhaps the rules are trying to say that the fact that individual 2 acquired shares in the company – other than by an arms-length bargain on the open market (impossible for private companies), means that a ' relevant arrangement' has taken place, and hence all dividends paid to individual 2 are part of that 'relevant arrangement'?

136. This still does not alter the fact that even one shareholder is not entitled to receive income until the dividends are voted.

137. The example in Box B.1 says " but this could just as easily be a company". This is not correct. Companies and partnerships operate differently. As partners have a right to receive a proportion of profits as set out in the partnership agreement or under the Partnership Act 1890. Shareholders do not have a right to receive any portion of income until dividends are agreed by the board.

138. The example in box B.2 seems to assume that individual 1 is both a shareholder and director of the company, but it does not say that individual 1 is a director or shadow director.

cl. 681F (b): work done by Individual 1

139. The phrase “having regard to any work done by individual 1 and all other relevant circumstances…” is by no means clear. However this seems to be the first test to be used by HMRC, para B49. This para states “ work done by individual 2 reasonably justifies the level of reward received’.

140. What does HMRC count as reward received:

- Just salary
- Salary plus benefits such as pension contributions
- All remuneration plus dividends?

141. When looking at the work done by individual 2 where are the boundaries drawn? If individual 2 supports the family by physical (being a mother/ carer/ housewife) or monetary (a salary from another source) means, to enable individual 1 to start and grow the business should individual 2 not be rewarded for those efforts. The work done by individual 2 may be indirect, in that it is a supporting role for the business, but it would be recognised by the divorce courts. There is a strong argument for looking at a family business in the widest sense. The boundary of the business does not stop at the balance sheet.

AM
19/02/08

ANNEX 1

ICAEW AND THE TAX FACULTY: WHO WE ARE

1. The Institute of Chartered Accountants in England and Wales (ICAEW) is the largest accountancy body in Europe, with more than 128,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.

2. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department for Business, Enterprise and Regulatory Reform through the Financial Reporting Council. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy, including taxation.

3. The Tax Faculty is the focus for tax within the Institute. It is responsible for tax representations on behalf of the Institute as a whole and it also provides various tax services including the monthly newsletter *TAXline* to more than 10,000 members of the ICAEW who pay an additional subscription.

4. To find our more about the Tax Faculty and ICAEW including how to become a member, please call us on 020 7920 8646 or email us at taxfac@icaew.com or write to us at Chartered Accountants' Hall, PO Box 433, Moorgate Place, London EC2P 2BJ.

THE TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. **Statutory:** tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. **Certain:** in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. **Simple:** the tax rules should aim to be simple, understandable and clear in their objectives.

4. **Easy to collect and to calculate:** a person's tax liability should be easy to calculate and straightforward and cheap to collect.

5. **Properly targeted:** when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. **Constant:** Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. **Subject to proper consultation:** other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. **Regularly reviewed:** the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. **Fair and reasonable:** the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. **Competitive:** tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as **TAXGUIDE 4/99**; see http://www.icaew.co.uk/index.cfm?route=128518.

ANNEX 3

COMPARISON WITH OTHER OECD COUNTRIES

According to a 2002 survey thirteen OECD countries allow income splitting for any form of income and indeed consider it quite normal, including the US, France and Germany. Canada has recently joined them for pensioners and is considering extending this to other taxpayers.

The US position is explained on the Internal Revenue Service website at http://www.irs.gov/formspubs/article/0,,id=164272,00.html, which has the 2007 federal tax rate schedules. Those who are 'married filing separately' have tax bands of up to $7825 at 10%, from there up to $31,850 at 15%, from there up to $64,250 at 25% etc. If you are 'married filing jointly' all these bands are exactly doubled.

The French position can be found on a document published by the Administration Fiscale (the 'Fisc') in English at http://www.impots.gouv.fr/portal/deploiement/p1/fichedescriptive_1006/fichedescriptive_1006.pdf - this is dated 2005 but we understand that the principles have not changed. Page 16 explains that 'tax is assessed at the level of the "tax household"', and further details are given on page 30. In France, income is split not only with the spouse, as in the US, but their version of civil partners as well (which includes registered but unmarried heterosexuals) and dependant children. Apart from the first two children, who count as half each, they add up the number of people in the household and apportion the income between them – a couple with six children is likely to pay very little tax.

Germany's system operates in the same way as the American one, in that it is confined to spouses and all the bands are simply doubled. Details are available at http://www.london.diplo.de/Vertretung/london/en/01/Living__and__Working/External__websites/UK__German__tax__DownloadDatei,property=Daten.pdf, which is a publication of the German Embassy.

PARAGRAPH 1.9, BOX 1.1 EXAMPLES

The figures in these examples, which are used to build the case for these proposals, are misleading. The calculations have omitted the corporation tax which a company must pay. In order to make meaningful comparisons, the national insurance payable by an individual or partnership must also be taken into account.

Based on a business which makes a taxable profit of £60,000 and tax rates for 2007/08, the correct comparisons would be as follows:

Business set up as a company

	Nina as 100% shareholder	Nina and Charles owning 50% each (combined charge)	
Taxable profits	60,000	60,000	
Corporation tax at 20%	12,000	12,000	
Profit available for distribution	48,000	48,000	
Gross dividend	53,333	26,667	26,666
Personal allowance	5,225	5,225	5,225
Taxable	48,108	21,441	21,441
34,600/21,441 taxable at 10%		All at lower rate so nothing additional to pay	
13,508 at higher rate 32.5%	4,390		
	4,390	Nil	Nil
Less tax credit on dividend taxed at higher rate	1,351		
Income tax payable	3,039	Nil	Nil
Corporation tax	12,000	12,000	
Total tax charged	15,039	12,000	

Tax saving resulting from joint ownership of the company is £3,039

Business remains unincorporated

	Nina as sole trader	Nina and Charles as equal partners	
Taxable profit	60,000	30,000	30,000
Personal allowance	5,225	5,225	5,225
Taxable	54,775	24,775	24,775
Income tax			
2,230 at 10%	223	223	223

32,370/22,545 at 22%	7,121	4,960	4,960
20,175 at 40%	8,070		
	15,414	5,183	5,183
Class 2 NIC	114	114	114
Class 4 NIC			
8% x (34,840 – 5,225)	2,369		
8% x (30,000 – 5,225)		1,982	1,982
1% x 25,160	252		
Total	18,149	7,279	7,279

Tax saving resulting from partnership is £3,591

ANNEX 5

RESPONSE TO CONSULTATION QUESTIONS AT PARA 1.21

The consultation documents asks for comments on 6 specific questions. We considered that merely to answer these would be too simplistic and have instead prepared a more detailed response.

Brief comments are made below together but these should be used in conjunction with the main body of this response.

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?

Whilst this may indeed capture income shifted in the situations envisaged, it is likely to do so at great administration cost to business, tax advisers and to HMRC. At the same time, there are no existing mechanisms to establish electronically through the self assessment systems for individuals and companies, how much revenue this legislation will raise.

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?

We have explained why the legislation will adversely impact on those businesses which are not caught by the rules but who need to undertake considerable work to establish this. If the rules cannot be better targeted, then we suggest that smaller businesses are exempted from the operation of the rules and that this area is then revisited in light of the on-going small business review.

3. In what ways could the legislation and guidance provide greater clarity for businesses and their advisers, enabling them to understand when income has been shifted and what to do in these circumstances?
We disagree with lengthy guidance being used to achieve clarity for poorly targeted legislation. The consultation launched in December 2004, *Small Companies, the self-employed and the tax system*, identified many of the problems with the way that small businesses are taxed under the current system. Discussions on how best to tax profits from small businesses need to be revived so that taxation in this area can be simplified and the associated costs reduced. We would suggest the long-term solution is to re-energise this review to deal with all interlinking areas of small business taxation rather than 'sticking plaster' rules such as 'income shifting' which we believe will create more problems than it solves.

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?

See response to 2 above.

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?

We have explained in detail the considerable problems associated with these proposals working properly in a self assessment system. These range from the difficulties and costs associated with valuing a person's contribution to a business to breaches of taxpayer confidentiality.

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?

The consultation stage impact assessment shows a fundamental lack of understanding of the tax system. The costs are understated, the revenue is understated. Neither sets of figures seem sufficiently reliable for decision making.