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'Income Shifting' – How it might affect you

The Arctic Systems case has been much talked about over recent years. The case involved a husband and wife who owned a company 50/50 and, broadly, took the profits out by way of dividends, again 50/50. HMRC attempted to tax the dividends solely on the husband, as he was performing most of the work which generated the profits of Arctic Systems.

Following HMRC's defeat in this case, the government has published a consultative document which includes draft legislation to prevent a tax advantage being gained through what has become known as 'income shifting'. This legislation will potentially apply from 6 April 2008 to:

- private company dividends; and
- profits from a partnership.

It will not affect dividends from a quoted company or investment income from savings accounts or from rental property (as long as the rental income does not arise from a partnership business).

It is broadly designed to address the Arctic Systems sort of situation, where one spouse or civil partner generates most of the business profits but the other gets a proportion of the profit and, overall, the couple save tax into the bargain. However, the proposed rules are very widely drafted and may catch many owner-managed businesses involving husbands, wives and other family members, as well as businesses run by people who are living together but are not married.

The proposed legislation refers to an individual who shifts company dividends and partnership profits to another individual.

Three conditions have to apply:

- an individual who is shifting income is party to an arrangement or understanding, or can control or influence such an arrangement or understanding;
- that individual forgoes income (directly or indirectly), as it has been shifted to another individual; and
- the individual who is shifting the income has the power to control or influence the amount of the income shifted.

If these conditions are met, the individual who has shifted the income will be liable for the tax and any national insurance due on the income shifted.

This is an HMRC example of a situation in which the legislation would apply. 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.

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.

Of course, if Individual 2 does contribute more to the business than in the above example, then some or all of the income will not be treated as shifted income.

The legislation will not apply to:

- genuine commercial arrangements;
- 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; and
- situations where, even though income has been shifted, there is no tax advantage gained.

Please note that this is not yet legislation and is subject to a consultation process. We will, of course, be reviewing your tax position before April and will keep you informed of any further developments. However, if you have any questions or concerns in the meantime, please do not hesitate to contact us.

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