

New Provisions to Counteract Income Shifting

Having been defeated in the House of Lords in the *Arctic Systems* case, HMRC announced immediately afterwards that it would bring forward new legislation with the broad effect of reinstating the tax position which it argued for in that case.

It will be recalled that the scenario in *Arctic Systems* was that husband and wife each originally subscribed for one share in a newly formed company which was to conduct a consultancy business. The husband carried out the consultancy work of the company while his wife carried out administrative work totaling about 4 or 5 hours per week. Most of the profits were paid out in the form of dividends to the two of them.

In the past HMRC has always argued that these types of situations may be caught by the settlements legislation. This however has been widely disputed, particularly because that legislation contains an exclusion for cases where there is an outright gift from (for example) husband to wife and what is given is not wholly or mainly a right to income. The scope of that exclusion itself was not entirely clear, but the better view was always that ordinary shares in a limited company carried rights far beyond simply the rights to dividend income, even if the company has no assets. If however the company did have tangible assets on its balance sheet, even HMRC accepted that the ordinary shares were not wholly or mainly a right to income and the exclusion then applied.

As is well known, HMRC lost this particular argument in *Arctic Systems* at the House of Lords. Their Lordships held that ordinary shares, even in a private consultancy company, cannot be regarded as assets which are wholly or mainly a right to income and no more. Once HMRC loses a long running battle in the House of Lords, it will be very surprising indeed (on past experience) if it did not change the law thereafter, and this is exactly what is to take place with effect from 6 April next year. A consultative document with this in mind was published on 6 December 2007.

What we are to expect under the new regime is an anti-avoidance provision which applies where the following conditions are all met:

- 1 An individual is party to, or has power over, the 'relevant arrangements';
- 2 That individual forgoes income and the forgone income becomes that of another individual for a relevant tax year;
- 3 The first individual has power to control the amount of income that is shifted;
- 4 The shifted income consists of distributions of a company or profits of a partnership.

The proposed legislation will apply only in cases where the arrangements are not genuine commercial arrangements and where it would be reasonable to draw the conclusion that one of the main purposes of them is the avoidance or reduction of a charge to income tax.

It will be seen that a crucial factor in the new legislation is determining whether an individual has 'forgone income'. Many people form fledgling companies and in the early years embark upon a deliberate policy of not drawing out the income but instead leaving it in the company to build up the business. Once the company becomes more established, they may then feel able to draw out some of the profits as dividends. In future, it will be necessary to decide if this kind of activity is done on a non-commercial basis and also if it means that the main architect of the structure has gone about things in such a manner as to forgo some of his or her income. The examples given by HMRC in the consultative document are fairly straight forward, but in the multitude of arrangements set up by tax payers one can expect that there will be numerous cases where it will be very hard to decide whether or not that the legislation applies. Will there be some kind of clearance system by which one can obtain HMRC's view? Not according to the consultative document; it is left to the individuals and their advisors to flounder about reaching some kind of conclusion which HMRC can then challenge by way of opening an enquiry into the tax return after it has been submitted. That seems all entirely unsatisfactory and puts the onus on the tax payer to apply complex legislation which is ill-defined.

The proposed provisions go far wider than would have been the case if HMRC had simply succeeded in applying the existing legislation in accordance with its argument in the Arctic Systems Case. First and foremost, the old settlements provisions applied principally between husband and wife, but the new provisions apply in any circumstances where there is a shift of income from any one individual to another. Secondly, although HMRC was content previously with arrangements where income was shifted but the business had capital assets, there is no such exclusion in the new proposals. Another distinction is that the old provisions applied only where there was the provision of funds for a 'settlement' by one tax payer. The provision of free services was outside the scope of the legislation, not being the provision of funds, although it was sometimes possible to find some other feature of the arrangements, such as a guarantee to a bank, which could be regarded as the provision of money or monies worth. Nevertheless, simply working for a company for no payment was not the provisions of funds. This however is exactly what the new proposed legislation is designed to attack, and so this aspect goes far wider than the settlements legislation ever could have done.

It should be noted that the proposals will apply to partnership arrangements, in the same way that they apply to companies. The Government is seeking representations on the provisions by 28 February 2008 at the latest, and all those who feel that they may be adversely and unfairly affected should take the opportunity to make their views known. The contact for representations is James Miller, H M Treasury, 1 Horse Guards Road, London, SW1A 2HQ.

Commentary on the Arctic Systems case is set out in the July 2007 newsdesk article.

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