



Income shifting: a consultation on draft legislation

Submission to HM Revenue & Customs in response to the above named document issued December 2007

Richard Murphy FCA

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Introduction

This paper is submitted as a formal response to the issue by HM Revenue & Customs of a consultation paper entitled 'Income shifting: a consultation on draft legislation' in December 2007. It has been written by Richard Murphy FCA on behalf of Tax Research LLP.

Summary

There is a problem with income shifting within the UK economy. It is, therefore, unfortunate that this issue has only been considered within the context of the small and medium sized enterprise in the proposed legislation to which the consultation refers. This undermines the credibility of the claimed principle base for that proposed legislation because much of the income shifting that takes place within the UK taxation system is ignored as a result. A comprehensive approach to the problem of income shifting is needed if the claims made by HM Revenue & Customs in their consultation paper are to be justified.

The limited scope of the proposed legislation does not prevent further problems arising. In particular, the proposals made show insufficient understanding of the nature of small and medium sized enterprises and the way in which they are managed. As a result the proposed legislation is inappropriate as a means of achieving the objectives set for it by the consultation paper and might as a result give rise to inconsistent application and potential for abuse in the hands of

individual HM Revenue & Customs employees. This could be overcome if the legislation were purposive, and contained statutory guidance on interpretation, but it does not meet these criteria.

The result is that whilst it is desirable that legislation be created to tackle income shifting that proposed might give rise to unreasonable challenge to small businesses, might result in unfair taxation charges that do not reflect the economic substance of the transactions that have taken place or might simply give rise to vexatious taxation enquiry. This is unacceptable.

These problems could be overcome but only if the government is willing to withdraw these hastily drafted proposals. This report recommends that:

1. The consultation period for this new legislation be extended by one year;
2. That the approach to legislation on income shifting should be broadened to cover, for example, the shifting of capital gains within familial relationships and appropriate arrangements for the splitting of investment income in such relationships;
3. That any review of income shifting by small business should be undertaken at the same time as a review of the forms of corporate structures available for use by small and medium sized enterprises in the United Kingdom to ensure that those available provide the greatest opportunity for both enterprise and tax compliance;
4. Appropriate mechanisms for identifying the return due to enterprise, which is commonly called profit, within a small and medium sized entity should be established and the means of either measuring, or approximating the measurement of that return should be agreed;
5. An appropriate and consistent basis for the taxation of profit should be established to replace the dichotomous approach now found in the UK's income tax and corporation tax systems. In the first of these taxes the return to profit is currently taxed as earned income and in the second it is treated as unearned income. It is this differing approach that has helped create the problem now called 'income shifting'. Until it is decided whether separate and distinct rules are required for the taxation of profit that might differ from those used for the taxation of the return to labour, capital and land then this problem cannot be resolved. Alternatively, and as we believe appropriate, the government must make clear if it is now its aim to treat income from all sources as similar, meaning that as far as possible all income will be treated consistently for taxation and national insurance purposes. Unless and until these issues are resolved no strategy on income shifting can have a credible basis;

6. That the legislation to be introduced to achieve the government's stated objectives should be constructed purposively, be implemented through regulations with the force of statute that have been subject to widespread consultation and regular review and that any abuse of the purpose of the legislation by HM Revenue & Customs should be capable of appeal by a taxpayer;
7. That HM Revenue & Customs publish clear guidance to be treated as having statutory status as to what they do and do not consider constitutes a commercial transaction for the purposes of the proposed legislation and what evidence they might require to prove the substance of that commercial purpose and that the version of this guidance in force at the time that a transaction takes place shall be considered binding upon HM Revenue & Customs for the purposes of interpretation of the proposed legislation;
8. That HM Revenue & Customs publish guidance on what constitutes an acceptable default position for the payment of reward to a participant in a business who provides either capital or management input or labour effort but who is not the accepted lead participant in the enterprise so that small business can enjoy certainty as to the maximum acceptable and normally unchallengeable reward payable to such a person in such circumstance.

These proposals, if adopted, would broaden the tax base, reduce opportunity for abuse, provide essential protections for the taxpayer and increased certainty as to the basis on which they could self assess their income without fear of penalty arising, would encourage enterprise and would promote horizontal and vertical equity within the tax system as well as creating an invaluable principles based approach to similar contentious issues that might require legislation in future. It is for all these reasons that we recommend less haste and more time for consideration at this moment, whilst making clear our commitment to the government's objective of ending tax abuse through income splitting.

Background

Tax Research LLP believes that the issue of income shifting is a matter of concern within the UK taxation system. Some of the reasons for thinking so were explained in a paper written by Richard Murphy FCA and published by Tax Research LLP in August 2007 under the title 'Small Company Taxation in the UK: A review in the aftermath of the 'Arctic Systems' Ruling'. This paper is attached as Appendix 1 to this submission and should be considered an integral part of it.

That paper considered how small business taxation and associated legal structures used by small and medium sized enterprises could be adapted to promote the concept of tax compliance in the twenty first century. It is important to note that in this context and in this submission tax compliance is assumed to be the process

of seeking to pay the right amount of tax at the right time and in the right place where ‘right’ means that the economic substance of the transaction undertaken and the form in which it is reported coincide.

The use of this definition necessarily means that Tax Research LLP promotes the idea that:

1. Tax is paid by the person who either generates an income or beneficially owns the assets that give rise to a return to capital;
2. When structures created by law (whether they be incorporated entities such as companies or limited liability partnerships or entities with unlimited liability recognised in law such as partnerships and trusts) are used for the management of economic activity the distortion to which they give rise within the taxation system should be kept to the minimum possible.

These principles are inherent in this submission.

It is also the case that Tax Research LLP believes that the credibility of any taxation proposal must be tested against two standards of equity, namely:

1. Horizontal equity, which requires that people on similar levels of income of whatever source and of similar social circumstance are subject to similar rates of taxation, and
2. Vertical equity, where it is required that those on higher levels of income so, subject to differences in their social circumstances and within limits determined by Parliament, pay a greater proportion of their income in tax than do those on lower income.

Both criteria will be used as a basis for assessment in this submission.

Fundamental issue of concern

Tax Research LLP welcomes the observations in paragraphs B3 and B4 of the consultation document, which say:

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.

It is apparent that the observations in paragraph B3 promote the concept of tax compliance, noted above whilst those in paragraph B4 reinforce that principle and are designed to promote the concepts of both horizontal and vertical equity. As a result both are appropriate statements of principle.

Regrettably these statements of intent are matched by the proposal then made within the consultation paper. The paragraphs following those noted above say:

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”.

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

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

Both these paragraphs are misleading as to the intent of the proposals and draft legislation that follows.

Paragraph B5 is misleading as to scope. The proposed legislation is not, as is stated, intended to *counteract the tax advantages obtained by the diversion of income to other persons*. This is because the practice of income shifting is commonplace elsewhere in the tax system and is not restricted to partnerships and returns from privately owned companies. Other forms of income shifting commonly undertaken include:

1. The sharing of investment income between spouses, a situation that is so commonplace that equal sharing is assumed to be the default position by HM Revenue & Customs when more than one person is named as the recipient of investment income irrespective of evidence of ownership of the assets giving rise to that income, especially within a marriage or civil partnership. This form of income shifting is therefore specifically endorsed by HM Revenue & Customs unless strong evidence to the contrary can be given by the taxpayers involved. This position is directly contrary to that assumed by the proposed legislation and no justification for this is given in the consultation paper.
2. Income is shifted to companies and trusts to take advantage of lower taxation rates and in many cases this either receives official endorsement or is not subject to sanction. This is particularly true if the income in question arises from a capital asset rather than from human endeavour.
3. Income is converted into capital to take advantage of the lower taxation rates and additional allowances available for capital gains, and whilst anti-avoidance legislation to prevent such practice does exist it seems to be sparingly used to tackle such practices.

4. Capital assets are transferred between partners in a marriage or civil partnership for the purpose of exploiting lower rates of taxation and the utilisation of allowances for capital gains purposes and the practice is officially sanctioned within taxation legislation and never subject to challenge by HM Revenue & Customs.
5. Earned income is recategorised as investment income through the use of the medium of a limited company and the process is only rarely challenged where the activity giving rise to the income had commercial substance even if the resulting return on capital is wholly unrealistic. National insurance charges are blatantly avoided as a result. For the purposes of this submission national insurance charges are considered to be taxes.

None of these means of income shifting are tackled within the consultation paper to which this submission refers and there appears no intention to do so. As a result the consultation paper lacks credibility because it does not address the issue of income shifting to which it claims to refer.

This means that there is at the core of the paper as presented an unfortunate misrepresentation of intent that means that the planned legislation suffers from a severe disconnect from the statements of principle which give rise to it. Whether deliberate or otherwise, this disconnect means that the consultation paper as submitted lacks credibility because the arguments contained within it lack consistency. This has resulted in the expression of considerable disquiet, some of it well informed and some of it just angry, within the community of small and medium sized enterprises and amongst those professional people, firms and institutes who advise such enterprises. Given the inherently flawed logic of the proposals made in the consultation paper this submission adds its voice to those expressions of concern and suggests that the consultation period on the proposed legislation is too short for any serious amendment to be made. It is therefore the first recommendation of this submission that:

Recommendation 1

The period for consultation on the proposed new rules to tackle income shifting within the UK taxation system be extended until 28 February 2009.

Tackling the issues of concern

The issues of concern that have been identified by those who have commented on the consultation paper to which this submission refers might be summarised as:

1. That the scope of the proposed legislation is too narrow and that it should be extended to other forms of income shifting, and especially that which relates to investment income;

2. That the proposals made show insufficient understanding of the nature of small and medium sized enterprises and the way in which they are managed;
3. That the proposed legislation is inappropriate as a means of achieving the objectives set for it by the consultation paper and might as a result give rise to inconsistent application and potential for abuse in the hands of individual Revenue employees;
4. That the guidance provided gives insufficient certainty to those who work in small and medium sized enterprises and who might be subject to the proposed legislation to ensure that arrangements that are tax compliant (as defined in this submission) can be used by the entities and people in question with confidence that they will not give rise to unreasonable challenge, taxation charge or vexatious taxation enquiry.

These concerns are shared by Tax Research LLP and are elaborated in the following sections of this submission.

Income shifting - broadening the scope in the interests of equitable taxation

All income shifting of the sorts previously described in this report and in its appendices give rise to taxation abuse in that they create situations which are inconsistent with the principles of tax compliance as defined in this submission.

So, for example, artificial income shifting within a small and medium sized enterprise so that the value of earned income generated by one person is paid to another does mean that tax is not paid by the right person, and any such action cannot be tax compliant. It is understood that this is the practice which the proposed legislation intends to address.

However, it is also true that the artificial splitting of investment income within a marriage or civil partnership without considering the true beneficial ownership of the underlying asset is as abusive of the principle of tax compliance. The commonplace practice of shifting the ownership of assets between partners to a relationship recognised in law prior to disposal to minimise capital gains tax is also an abuse of the principle of tax compliance.

All such practices abuse the principles of horizontal equity because a single person without access to such mechanisms will in all these cases pay more tax than will a couple able to take advantage of these arrangements, and it would appear from the statements of principle noted above (paragraphs B3 and B4 of the paper) that all of these are unacceptable. As a result of these unacceptable activities the principle of vertical equity which it is intended should be present in the UK system of taxation of income is being abused.

However, to tackle one of these issues in isolation is to merely highlight a particular disquiet about that activity above all others, suggesting a greater significance is afforded to abuse in this area than in others, and so suggesting that those others are, therefore more acceptable in the eyes of legislators and society in general.

The consultation paper does not attempt to suggest why it considers the income shifting it seeks to address is of greater significance or more abusive than is the other income shifting noted in this submission. Nor does it at any point offer a reason as to why the Government considers this particular form of tax non-compliance unacceptable to society when other forms of similar activity with similar or greater consequences for its revenues are not to be addressed. Because of this failure the consultation paper fails to make the case for the proposed reform.

As such, whilst in broad principle Tax Research LLP supports measures to tackle income shifting within small and medium sized enterprises it believes that these cannot be proposed in isolation or without justification being offered for this choice and as such it cannot support the legislation as proposed at present. This concern gives rise to the following recommendation.

Recommendation 2

That the existing proposals to tackle income shifting be withdrawn and be replaced by proposals that might tackle income shifting more generally, including that which is commonplace within the taxation of capital gains.

Income shifting - tackling the issues of small business taxation

An inherent weakness of the proposals now made is that they seek to remedy a perceived defect in small and medium sized business taxation without ever addressing the structural flaws in the mechanisms supplied by UK law for the pursuit of these activities. As appendix 1 to this report shows:

1. Limited companies designed in the 19th century are not fit for purpose for use by small entities in the 21st century UK;
2. The obstacles placed in the way disincorporation of small limited companies does at present prevent adoption of more appropriate forms of entity for use by small and medium sized enterprises;
3. The failure to promote the use of Limited Liability Partnerships by small and medium sized enterprises has meant that a real opportunity to tackle the problem of income shifting through the use of a genuinely flexible arrangement that can accommodate changing contributions of members of a business community over time has been a mistake by a range of government departments;

4. Clear guidance on how income may be allocated within a business must be provided if any widely acceptable system of small business taxation is to be created.

The last issue is dealt with in a later section of this submission; the others should be addressed using the mechanisms identified in Appendix 1. This gives rise to the following recommendation:

Recommendation 3

That the forms of corporate structures available for use by small and medium sized enterprises in the United Kingdom should be subject to critical review to ensure that they provide the greatest opportunity for both enterprise and tax compliance. This review should be undertaken by a commission which shall hear evidence in public and make its proposals available for independent scrutiny.

There are other issues that must also be addressed. Most particularly, the issue of the taxation of enterprise must be subject to proper review. At present this issue is not addressed by the UK taxation system. That system clearly identifies methods for tackling income resulting from the expenditure of human effort. This is generally called 'earned income'. It has also identified mechanisms for taxing the return to capital, which is generally called 'unearned income'. These two returns accord with the generally accepted economic returns of wages and interest resulting from the use of labour and capital. These are two of the so-called 'factors of production'. It so happens that the mechanisms used for the taxation of capital are broadly similar to those required for the taxation of land, which is the third factor of production from which income in the form of rent is derived.

The difficulty that is inherent within the UK taxation system is how to identify the return due to enterprise, which is the fourth and final traditional factor of production. In principle the mechanisms for the taxation of profit, whether in an incorporated entity or for an individual should achieve this result but do not in practice do so. In a corporate entity it is assumed that the income taxed is equivalent to the return on capital i.e. interest, and is to some degree taxed as such. For example, neither are subject to a national insurance charge and both are considered investment income in the hands of their final beneficial recipient. However, the application of the same rules to the case of an individual who is in trade (whether alone or in a partnership, and that whether incorporated or unincorporated) results in a charge that assumes that the profit is analogous to earned income and is, for example, subject to national insurance charges (albeit at slightly different rates to those levied on employment income) and is considered earned income.

It is this dilemma that is indicative of the problems inherent in, and unaddressed by the consultation paper on income splitting issued by HM Revenue & Customs.

The questions it by implication only poses and which as a result it never seeks to resolve might include the following:

1. What is business profit?
2. How does it differ from the returns to labour and capital?
3. Can these differing returns be identified when supplied by only one person, or in different and varying ways by a small and related group of individuals, whose contribution might also vary over time?
4. If this return could be identified how should it be taxed?
5. Does profit require a form of taxation that differs from both labour and capital, and if so why?
6. If that is the case, what form of taxation should this be and is identification of this mechanism important in resolving the conflicting opinions that arise on income shifting?
7. Alternatively, do all three simply describe different mechanisms for providing returns arising from economic activity within a market economy to those who participate in that process in varying ways and which should in the interests of horizontal and vertical equity be treated as similar when finally passed to them to support their chosen lifestyles with the varying mechanisms of supply to be treated as similarly as possible to achieve this goal?

Other questions could, no doubt, be posed. The issue is however clear: at the centre of the issue of income shifting is a paradox, which is that all parties to this debate believe that enterprise is critical to the well being of the UK economy and yet none have properly addressed the issue of how it might be identified for taxation purposes and how it should be properly taxed when that identification has successfully taken place. Since it is highly unlikely that the component elements in the income generated by an enterprise will be properly identified and allocated until this conundrum is resolved, and tax compliance will not be possible until it is since the economic form of the transaction cannot accord with its form of taxation reporting unless this issue is properly addressed, this issue must be considered before that of income shifting in small and medium sized entities can be properly dealt with in the debate on the future of taxation in the UK.

This gives rise to the following recommendations:

Recommendation 4

Appropriate mechanisms for identifying the return due to enterprise within a small and medium sized entity should be identified and the means of either measuring, or approximating the measurement of that return should be established. This task should be addressed by a committee of experts likely to broadly represent the groups with interest in this issue but to act independently of them and with the power to call for and commission evidence to support its conclusions. This committee should report before new draft

legislation on income shifting is presented for consultation and any consultation document should explicitly consider the recommendations that it makes.

Recommendation 5

A committee of experts should consider the appropriate basis for the taxation of the return due to enterprise with the explicit requirement that they consider whether separate taxation rules are required to encourage and support this activity which might differ from those used for the taxation of the return to labour, capital and land or whether the taxation system should instead consider whether the return from all such activities should instead be taxed on as similar a basis as is possible. This committee should report before new draft legislation on income shifting is presented for consultation and any consultation document should explicitly consider the recommendations that it makes.

Income shifting - the need for purposive legislation

Considerable concern has been expressed about the capacity of the proposed legislation on income shifting to be used indiscriminately, on a prejudiced basis and without recourse arising for the cost to a business of defending what it believes to be economically justifiable payments when challenged by HM Revenue & Customs. In particular:

1. Whilst the draft legislation is presented with statements of intent being made and explanatory notes being supplied these will not have the force of law and as such will not be a means of restraint on the actions of tax inspectors who decide to use the resulting unencumbered legislation for purposes now envisaged, or indeed for purposes now stated to be beyond its scope.
2. The guidance notes do not provide those who will have to self assess their income and that of the organisations they manage with sufficient indication of acceptable and unacceptable methods of apportioning income in ways likely to be considered tax compliant on which they can rely in the event of dispute;
3. Record keeping is essential to the establishment of taxation liabilities and the proposed legislation is inadequate in providing guidance as to the books and records and other evidence that it is necessary to maintain to support taxation apportionments and allocations made in the areas which this legislation is intended to address.

The result is that this is bad law.

Tax Research LLP was responsible for drafting the Code of Conduct for Taxation issued jointly by the Tax Justice Network (TJN) and the Association for Accountancy and Business Affairs (AABA) in October 2007. The summary of that Code is attached to this submission as Appendix 2 and is explicitly to be considered apart of this submission.

Section 1a of that Code says:

The intention of legislation is clear and a General Anti-Avoidance Principle ('Gantip') is in use

In the discussion document that accompanies that Code¹ (page 7) it is suggested that any taxation system should be based on principles and it is demonstrated that appropriate principles for taxation can be deduced from the UN Universal Declaration of Human Rights. A principled approach to tax legislation would undoubtedly remedy many of the flaws in the proposed legislation to which the consultation paper refers. Most particularly though, the TJN/AABA Code of Conduct argues that (page 12):

The purposive approach inherent in the draft Code of Conduct suggests the final key component in any system promoting tax compliance should be a General Anti-Avoidance Principle as a central component part of taxation law. It is stressed that a principle and not a rule should be used: a rule presupposes a legal interpretation of statute; a principle an equitable construction. The idea behind a General Anti-Avoidance Principle is simple: if a step is added to a transaction with the sole or principal aim of securing a tax advantage (which is defined as a saving in tax) then that step in the transaction is ignored for tax purposes. In other words, it tackles pre-meditated attempts to subvert the intention of the tax system and is consistent with the management approach towards the regulation of taxation proposed here.

The existence of a General Anti-Avoidance Principle (now generally called a "Gantip") allows a government to pass purposive legislation. This is legislation that states the intention of the law that is being created and devolves responsibility for the detailed rules that actually make it work to the status of regulations. This offers a number of advantages:

- 1. Few politicians fully understand the details of the laws that they are asked to pass; it is much more likely that they will understand and be able to discuss purposive taxation law;*
- 2. The purpose of law will be clearer: taxpayers will have greater chance of understanding and complying with the law;*

¹ <http://www.taxresearch.org.uk/Documents/TaxCodeofConductFinal.pdf> accessed 31-12-07

3. *The detail of regulation can be devolved to those with appropriate expertise;*
4. *Appeal arrangements are needed to ensure that those who claim that regulation does not accord with the purposive legislation can be heard, and can have the claimed conflict ruled upon. This is a necessary judicial over-ride for the administrative function of the State which is almost always responsible for the detail of tax legislation;*
5. *Where a government intends to use legislation or regulation in a way that was not anticipated it will be obvious, and appeals should succeed. There will, therefore be greater obligation on governments to disclose their intent as to how they propose to use the legislation available to them and to not subsequently change it, which should increase certainty for taxpayers.*

In combination a Gantip, purposive legislation, equitable interpretation of the law, and a clear framework of the responsibilities of all parties, provides the following benefits:

1. *Clarity as to the purpose of the law;*
2. *The opportunity to adopt a management based approach to taxation, overcoming the almost insurmountable difficulties in determining the difference between tax evasion, avoidance and compliance;*
3. *An enhanced prospect of practical compliance with legislation designed to achieve that purpose;*
4. *A fairer method for appraising culpability when errors occur;*
5. *The chance for a taxpayer to object to inappropriate regulation through use of the Court system;*
6. *Greater certainty within any tax system.*

It is these benefits that the proposed Code of Conduct is intended to promote.

The subject of income shifting would appear to be one that is ideally suited for the trialling of purposive legislation. The purposive legislation (assumed in this case to extend to all income shifting in the interests of horizontal and vertical equity within the tax system) might say:

“When a person transfers an entitlement to receive income or gains that they might reasonably have been considered to have entitlement to enjoy to another taxable person, whether a natural person or otherwise, in circumstances where the transferor might continue to materially benefit from those income or gains after the transfer had been made and the transfer was made for the main or sole purpose of reducing or deferring the total taxation liability to which the transferor and transferee might have been liable if those income or gains had been received by the transferor then the transfer giving rise to that reduced taxation liability shall be

ignored by both the transferor and transferee when declaring their income or gains for taxation purposes and the income or gains to which benefit has been transferred shall be declared as that of the transferor, who shall also make disclosure of the arrangement that has been ignored for taxation purposes.”

Such legislation would quite specifically:

1. Exclude from consideration all genuine gifts from which the transferor was precluded from all likely future benefit;
2. Exclude from account all transfers for which genuine commercial or non-taxation reasons could be demonstrated (but such demonstration would need to be evidenced);
3. Permit all payments of a commercial nature.

The test for acceptability could be simply applied:

1. Was there a transfer of a right to receive income or gains? If not, then the issue requires no further consideration.
2. Was the transferor able to enjoy the benefit of that income or gain after the transfer had taken place? If not then, again, the issue requires no further consideration. Benefit would, however, be widely interpreted.
3. If the transferor was able to benefit from the income or gain transferred was there a commercial justification for the legislation that could be demonstrated by the parties involved? If yes then the issue does not require disclosure. If not, then the transfer would be considered null and void.

This process achieves the objectives of the proposed legislation put forward by HM Revenue & Customs but does so with the following additional safeguards:

1. The legislation would require that guidelines be published on interpretation of the proposed arrangements and these would be considered binding upon HM Revenue & Customs. HM Revenue & Customs would be required to consult widely on such regulation and any change in them and to publish their reasoning for accepting or rejecting submissions and comments made.
2. Because these regulations would be created by Statutory Instrument they could be amended in the light of experience.
3. An appeal against abuse of the purposive legislation by HM Revenue & Customs would be available so that its scope could not be extended without consent.

If the scope of the legislation were to be more limited, and to apply only to income from partnerships and company distributions, then the wording of the proposed legislation would say:

“When a person transfers an entitlement to receive income or gains derived from a trading partnership or dividend income from limited company pursuing a trade that they might reasonably have been considered to have entitlement to enjoy to another taxable person, whether a natural person or otherwise, in circumstances where the transferor might continue to materially benefit from those income or gains after the transfer had been made and the transfer was made for the main or sole purpose of reducing or deferring the total taxation liability to which the transferor and transferee might have been liable if those income or gains had been received by the transferor then the transfer giving rise to that reduced taxation liability shall be ignored by both the transferor and transferee when declaring their income or gains for taxation purposes and the income or gains to which benefit has been transferred shall be declared as that of the transferor, who shall also make disclosure of the arrangement that has been ignored for taxation purposes.”

The scope is now restricted, but the benefits to the taxpayer remain.

This therefore gives rise to the following recommendation:

Recommendation 6

That the legislation to be introduced to achieve the government’s stated objectives should be constructed purposively, be implemented through regulations subject to widespread consultation and regular review and that any abuse of the purpose of the legislation by HM Revenue & Customs should be capable of appeal by a taxpayer.

Income shifting - the need for clear guidance on what is a commercial transaction

Much of the comment from the accountancy profession and the small business community on the proposed legislation relates to the difficulty that it will create in determining what is, and what is not, acceptable evidence of a commercial payment that would both satisfy the requirements of the proposed legislation and the purposive replacement suggested above.

The benefit of purposive legislation is that the guidance notes and statements of intent now issued by HM Revenue & Customs would be considered evidence that might be used by a taxpayer as indication of the intent of HM Revenue & Customs in this matter. The problem of the proposed legislation is that this will not be the case. This does place the small business community at a significant disadvantage without clear guidance as to what HM Revenue & Customs do and do not consider constitutes a commercial transaction for the purposes of the proposed legislation and what evidence they might require to prove the substance of that commercial

purpose. A purposive approach would require that such guidance be published, and that it would be binding on HM Revenue & Customs. This gives rise to the following recommendation:

Recommendation 7

That HM Revenue & Customs publish clear guidance as to what they do and do not consider constitutes a commercial transaction for the purposes of the proposed legislation and what evidence they might require to prove the substance of that commercial purpose and that the version of this guidance in force at the time that a transaction takes place shall be considered binding upon HM Revenue & Customs for the purposes of interpretation of the proposed legislation.

This guidance must be based upon the reality of small business management within the United Kingdom. In the attached paper on Small Company Taxation in the UK (appendix 1) it is suggested that HM Revenue & Customs should make clear that:

1. That a rate of return may be paid on capital employed by a small company based on the owner combined capital and current accounts or upon any loans made available, with a value also being attributed to returns due to those supplying guarantees for loans, however secured. This should be a risk based return and so should be set at a reasonable interest rate of at least 10% (less any interest paid to a third party on the same balance in the case of guarantees). The balances used should be those at the start of an accounting year or the calculation becomes circular. This payment would be considered as investment income.
2. A part of the income of any small business be attributable to management activity including administration. This might be 10% of turnover up to a turnover limit of £200,000 with a flat £20,000 being allowed for enterprises above that size unless they wish to argue their case for another sum. This sum can be allocated as the reward for enterprise to members as those members see fit so long as all members who participate in the reward for labour effort expended receive a share of not less than $1/(1 + n)\%$ thereafter where n is the number of members. So, for example, where there are two partners only one of whom supplies services to clients and the turnover is £100,000 then £10,000 may be allocated to management activity: the partner supplying client services must receive £3,333 but the balance could be paid to another member without question being asked. This income would be considered earned income.
3. The remaining reward shall be split in the ratio of the effort expended by those supplying services on behalf of the business to its customers, or who can be shown to have a key role in doing so if not facing the supplier themselves. This is largely a matter of fact. In the Arctic Systems case it

was obvious that only the husband had the necessary skills to supply the IT services that the company contracted to deliver. This will be so in the vast majority of such cases. If it is not then the business may put forward alternative argument as to why income should be allocated differently if it so wishes, with evidence being required to support the claim. This evidence will form part of the required books and records of the business. Guidance on how the partner delivering services to the client is to be determined would need to be issued. Possible bases for allocation might be:

- i. Time expended;
- ii. Evidence of management input e.g. attendance at business premises, meetings, client premises, emails sent, etc.;
- iii. Evidence of key services supplied e.g. technical input, invoicing, project management, product sourcing, etc.

Any combination of these may be used, and others as considered appropriate. Contemporaneous evidence of participation would be required. At worst this might be a log or time sheet. More likely it will be the evidence of actual participation that the day to day management processes of many businesses involve e.g. email, mobile telephone usage, documentary trails, etc will provide all the evidence that is required without any additional paperwork being necessary to support any likely reasonable claim.

If no evidence can be supplied of a split in these categories (and many companies are very bad at keeping any form of audit trail of what they do) then the default position will be that all labour effort expended will be assumed to be undertaken by the partner most technically skilled to undertake the services the organisation has contracted to supply, so placing the onus of proof on the taxpayer.

It is not suggested that this technique will produce a perfect solution in every case: that is not possible. What it does do is produce an acceptable default position for situations where the partners / members are related, turnover is relatively small (it is assumed that this model would not be used if turnover exceeded £200,000), the LLP supplies the services of one or more of its members in the main and at least one partner's role in the business is to supply support services relating primarily to management and administration matters.

This gives rise to recommendation 8:

Recommendation 8

That HM Revenue & Customs publish guidance on what constitutes an acceptable default position for the payment of reward to a participant in a

business who provides either capital, or management input or labour effort but who is not the accepted lead participant in the enterprise so that small business can enjoy certainty as to the maximum acceptable and normally unchallengeable reward payable to such a person in such circumstance, given the economic reality that in the case of most small enterprises owned by persons in a familial relationship secondary participant does take an active role in the management of the business that might be hard to prove with documentary evidence; it always being noted that if no evidence of any form of involvement can be provided then such payment could not be made.

Conclusions

There is a problem with income shifting within the UK economy. It is, therefore, unfortunate that this issue has only been considered within the context of the small and medium sized enterprise in the proposed legislation to which the consultation refers. This undermines the credibility of the claimed principle base for that proposed legislation because much of the income shifting that takes place within the UK taxation system is ignored as a result. A comprehensive approach to the problem of income shifting is needed if the claims made by HM Revenue & Customs in their consultation paper are to be justified.

The limited scope of the proposed legislation does not prevent further problems arising. In particular, the proposals made show insufficient understanding of the nature of small and medium sized enterprises and they way in which they are managed. As a result the proposed legislation is inappropriate as a means of achieving the objectives set for it by the consultation paper and might as a result give rise to inconsistent application and potential for abuse in the hands of individual HM Revenue & Customs employees. This could be overcome if the legislation were purposive, and contained statutory guidance on interpretation, but it does not meet these criteria.

The result is that whilst it is desirable that legislation be created to tackle income shifting that proposed might give rise to unreasonable challenge to small businesses, might result in unfair taxation charges that do not reflect the economic substance of the transactions that have taken place or might simply give rise to vexatious taxation enquiry. This is unacceptable.

These problems could be overcome but only if the government is willing to withdraw these hastily drafted proposals. This report recommends that:

1. The consultation period for this new legislation be extended by one year;
2. That the approach to legislation on income shifting should be broadened to cover, for example, the shifting of capital gains within familial relationships and appropriate arrangements for the splitting of investment income in such relationships;

3. That any review of income shifting by small business should be undertaken at the same time as a review of the forms of corporate structures available for use by small and medium sized enterprises in the United Kingdom to ensure that those available provide the greatest opportunity for both enterprise and tax compliance;
4. Appropriate mechanisms for identifying the return due to enterprise, which is commonly called profit, within a small and medium sized entity should be established and the means of either measuring, or approximating the measurement of that return should be agreed;
5. An appropriate and consistent basis for the taxation of profit should be established to replace the dichotomous approach now found in the UK's income tax and corporation tax systems. In the first of these taxes the return to profit is currently taxed as earned income and in the second it is treated as unearned income. It is this differing approach that has helped create the problem now called 'income shifting'. Until it is decided whether separate and distinct rules are required for the taxation of profit that might differ from those used for the taxation of the return to labour, capital and land then this problem cannot be resolved. Alternatively, and as we believe appropriate, the government must make clear if it is now its aim to treat income from all sources as similar, meaning that as far as possible all income will be treated consistently for taxation and national insurance purposes. Unless and until these issues are resolved no strategy on income shifting can have a credible basis;
6. That the legislation to be introduced to achieve the government's stated objectives should be constructed purposively, be implemented through regulations with the force of statute that have been subject to widespread consultation and regular review and that any abuse of the purpose of the legislation by HM Revenue & Customs should be capable of appeal by a taxpayer;
7. That HM Revenue & Customs publish clear guidance to be treated as having statutory status as to what they do and do not consider constitutes a commercial transaction for the purposes of the proposed legislation and what evidence they might require to prove the substance of that commercial purpose and that the version of this guidance in force at the time that a transaction takes place shall be considered binding upon HM Revenue & Customs for the purposes of interpretation of the proposed legislation;
8. That HM Revenue & Customs publish guidance on what constitutes an acceptable default position for the payment of reward to a participant in a business who provides either capital or management input or labour effort

but who is not the accepted lead participant in the enterprise so that small business can enjoy certainty as to the maximum acceptable and normally unchallengeable reward payable to such a person in such circumstance.

These proposals, if adopted, would broaden the tax base, reduce opportunity for abuse, provide essential protections for the taxpayer and increased certainty as to the basis on which they could self assess their income without fear of penalty arising, would encourage enterprise and would promote horizontal and vertical equity within the tax system as well as creating an invaluable principles based approach to similar contentious issues that might require legislation in future. It is for all these reasons that we recommend less haste and more time for consideration at this moment, whilst making clear our commitment to the government's objective of ending tax abuse through income splitting.

Appendix 1

Small Company Taxation in the UK:

A review in the aftermath of the ‘Arctic Systems’ Ruling

Richard Murphy FCA

August 2007

Summary

This paper analyses the way in which the owners of many small limited companies reward themselves and members of their families out of the income that their labour generates for those companies. This is particularly relevant in the light of the recent House of Lords ruling in what is known as the ‘Arctic Systems’ case. The paper shows that many of these arrangements do constitute tax avoidance because the rewards paid do not match the underlying economic substance of the transactions that are taking place.

In the interests of promoting tax justice for all taxpayers HM Revenue & Customs have a consequent duty to promote new arrangements that will encourage tax compliant behaviour in this sector. Tax compliance is defined as paying the right amount of tax (but no more) in the right place at the right time where ‘right’ means that the economic substance of the transaction accords with the declaration made for taxation purposes.

The paper does then show that this problem is almost insoluble whilst these businesses are operated through the medium of small limited companies which were not designed for and are unsuitable for the type of activity they undertake.

As a result this paper proposes that:

1. A change in company law to allow the re-registration of small limited companies as LLPs. An LLP is tax transparent: its income is taxed as if it belongs to its members even though it is a legal entity that is separate from them for contractual purposes;
2. The introduction of new capital requirements for the incorporation of limited companies undertaking trades, and over time forced re-registration of those that do not meet that standard as LLPs;
3. The introduction of a new investment income surcharge at rates broadly equivalent to national insurance charges that would have the benefit of reducing the incentive to split income, restore the taxation balance between income earned from all sources and allow a reduction in the base rate of income tax without adding substantially to the burden of administration of taxpayers since those liable will, in the vast majority of cases, already be submitting tax returns;
4. Create new, economically justifiable and verifiable standards for splitting income in LLPs so that the risk of legal challenge to such arrangements will be substantially reduced whilst recognising the significant role that the partners of those who supply their services through owner managed corporate entities play in the undertaking of that activity.

If this were done then:

- a. The administrative burdens for many small businesses would be decreased;
- b. The certainty of the arrangements under which they can operate would be increased;
- c. The rewards that they rightly seek to pay to those who contribute to the management of these companies from within domestic relationships will be rewarded, but within appropriate constraints;
- d. The attraction of freelance status in tax terms would be retained;
- e. The current injustice that sees income from labour more heavily taxed in the UK than income from capital would be eliminated in large part without prejudicing the required favoured status of pensioners;

- f. The incentives for tax planning would be reduced, so simplifying tax administration;
- g. The tax yield might either rise, or a reduction in the tax rate might result.

The challenge in creating such a system is significant because it requires cooperation across government departments, but far from insurmountable. It is part of the challenge of creating an enterprise culture that meets the needs of the UK in the 21st century, and that is a challenge that any government needs to meet.

Background

The debate on the taxation of small companies has always generated considerable heat. The ruling by the House of Lords in case of *Jones v Garnett* in July 2007, (otherwise known as the ‘Arctic Systems’ case after the name of the limited company to which it related) has only added to the intensity of that debate. This has in turn been fuelled by announcement of the government’s intention to legislate to achieve the result that they failed to secure through the Courts using existing legislation in this case. Given that the government has also announced that this process will involve consultation this seems an opportune moment to explore the issues of concern to them, and to explore ways to resolve those issues which do not pose a significant burden upon the economic effectiveness of small companies in the UK.

The economics of the Government’s claim

The first thing that is required is an economic analysis of the logic inherent in the government’s claims. Since this appears to have been little understood, such an analysis should add a rationale to discussion which does, on occasion appear to be missing. What follows is a model of small business taxation through the medium of a limited company from an economic perspective. To simplify the presentation most of the analysis is undertaken using diagrams, but some assumptions and acronyms will need to be defined at the outset.

First, it is assumed that a limited company owned by two people is being considered. They are called Husband (H) and Wife (W). They need not be

legally related, but I'm assuming they do not have a third party relationship either.

It is also assume that this business does not have all the hallmarks of a trade that are easily identified e.g. significant capital investment in stock, fixed assets or working capital. It may or may not have business premises: they might be in the family home. It supplies services, not goods. Costs incurred in proportion to the value of services supplied would, if the company operated at near capacity, be low. Profit margins are high and marginal income over a relatively modest level can largely be equated almost directly to funds available for distribution to the members in some form or other, what the form should be being the core focus of this paper.

The contributions made to the limited company by H and W to generate the income it earns (it being assumed that it cannot generate profit of its own freewill, about which I think there will be relatively little dispute, interest on cash deposits aside in this case) are:

1. Capital. This is the money subscribed for the shares H and W own in the company. We'll call it C and the part paid in by the husband will be HC and the wife WC. It also includes the retained profit of the company, but given its low capital requirements this is likely to be minimal and does not distort the analysis offered here.
2. Effort. This is hours expended in pursuit of the income generated by the company. It is labour contribution for which the economic reward is a wage or salary. We'll call this S. That attributable to the husband is HS and that to the wife WS.
3. Enterprise. This is the inspiration that gives the company the competitive edge in the market in which it operates. This is, of course, related to human endeavour but is of a different form. It is about management foresight. It can come as a flash of inspiration and might represent a better charging model, a better delivery mechanism, the choice of a good name or logo, or an appropriate management structure, for example. It can, of course, require effort expended over time and this is hard to differentiate from the Effort of the type noted above. It is however the return for business acumen: it is the activity that generates a return above the normal for labour time expended. Conversely it is also that process which can result in the benefit of labour effort being lost through it being

misdirected. We'll call this E and that due to the husband is HE and that to the wife is WE.

Combining these gives rise to the following diagram:

Diagram 1

| | |
|-----------|-----------|
| HE | WE |
| HS | WS |
| HC | WC |

The area of the diagram represents the net income pre tax, salaries to H and W, and dividends but after all other costs (with their associated tax cost if disallowable for taxation purposes) available for distribution to the two participants in the company. This is not, of course, fixed.

Relating the economics to the structure of a limited company

There are only two effective ways at present to pay these rewards as a result of the combination of company and taxation law. The first is by way of salary, which is appropriate for the payment of HS and WS. Dividends are the closest distribution available in law for the payment of HE, WE, HC and WC. Unfortunately, there is no way of differentiating them. Interest cannot usually be paid on capital in a small company.

In practice HC and WC often closely equate to interest. This is also, in no small part, what the dividends paid by quoted companies approximate to. The analogy is not perfect, but the movements in stock markets based upon changes in interest rates clearly suggest the association. The association is good enough for the current purpose. In that case the return in the vast majority of companies of the type being considered would be tiny. That is because even having allowed for the risk inherent in small companies

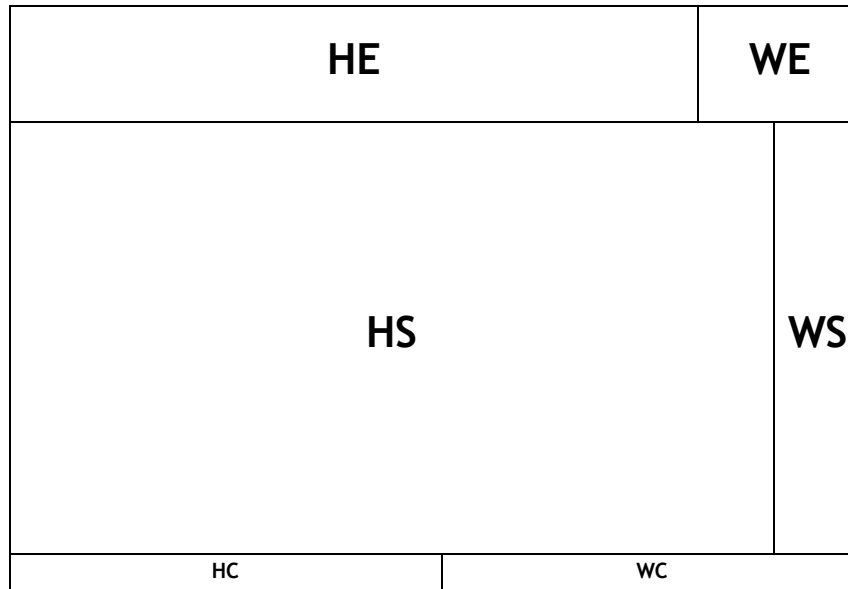
inflating the required interest rate to a level well in excess of that which is commonly quoted in the money markets the actual absolute amount of the payment made would remain small: these companies tend to have very small capital sums invested in them precisely because they have limited use for that money. Total sums invested of only £1,000 or so are commonplace in this sector. Even if interest rates of 20% were charged this would still make the combined total of HC and WC just £200. In almost all cases that will be immaterial to the distribution of reward from the company.

However it can be argued that HE and WE can also only be properly paid through dividends on share capital in an enterprise of this sort. But as the House of Lords and previous rulings in the Arctic Systems case have noted, such returns may vary from year to year. With ordinary share capital usually being fixed, varying dividends on different classes of shares being frowned upon by tax authorities, and the transfer of shares between husbands and wives to achieve this result also being likely to result in considerable questioning from tax authorities if undertaken regularly (and potentially involving other costs) once the share capital of the company has been subscribed for, very often before trading by the limited company has commenced, the ratio in which HE and WE can be paid has been set, whether it is right or wrong.

The reality of small business economics

It is unlikely that the labour input of the husband and wife will be similar in many small companies. It is also unlikely that their entrepreneurial input will be similar. It is uncommon for companies of the type under consideration here to be partnerships of equals: the trade that the company undertakes usually reflects the professional skill of one of the parties to which the other offers support. As such a possible diagram reflecting the economic rewards due to the two parties might be as follows:

Diagram 2



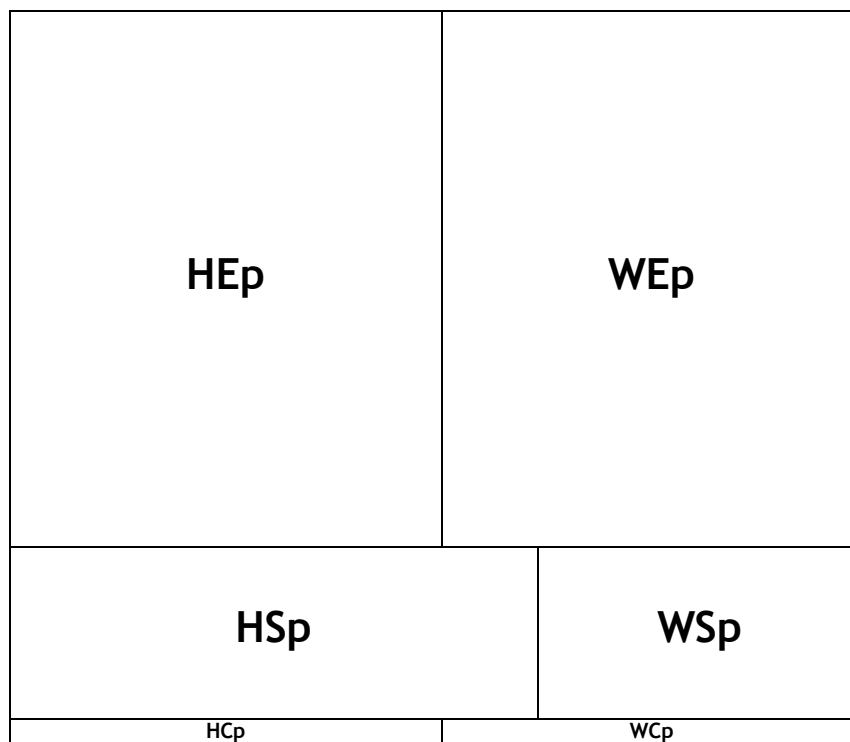
The terms W and H could be, and often are, reversed.

The point this diagram makes are this:

1. The returns to labour, enterprise and capital are unlikely to be equal;
2. There is no reason why the ratio of contribution of effort made by the two partners need be equal;
3. There is no reason why the ratio of return due to enterprise and capital need be the same even though dividends are the only reasonable means available for paying that return which arises over and above the reasonable rate due for the labour expended by the share owning participants in the company.

This seems obvious. The problem that arises is that under current law it would despite this be entirely possible to distribute the rewards shown in Diagram 2 earned in the way shown in the following diagram:

Diagram 3



The overall dimension of the diagrams is meant to be identical, even if word processing produces a slightly different result.

In this diagram the letter 'p' has been added to each term to indicate a payment made in the form described rather than the sum earned. So, and for example, HSp is the payment made in the form of remuneration for labour services supplied by the husband, which contrasts with HS which is the value of the economic sum actually attributable to that person resulting from their expenditure of effort in that way.

A measure of the problem

It is apparent that in this case, the following holds true by comparing diagrams 2 and 3, which relate to the same entity:

$$(HCp + HSp + HEp) < (HC + HS + HE)$$

In other words, the total paid to the husband for taxation purposes is less than the total sum that he has earned when assessed economically. It follows that the wife in this partnership is being paid more than she has actually economically earned. This arrangement is, for taxation purposes, called income splitting.

It is also true that in this case both the following hold true:

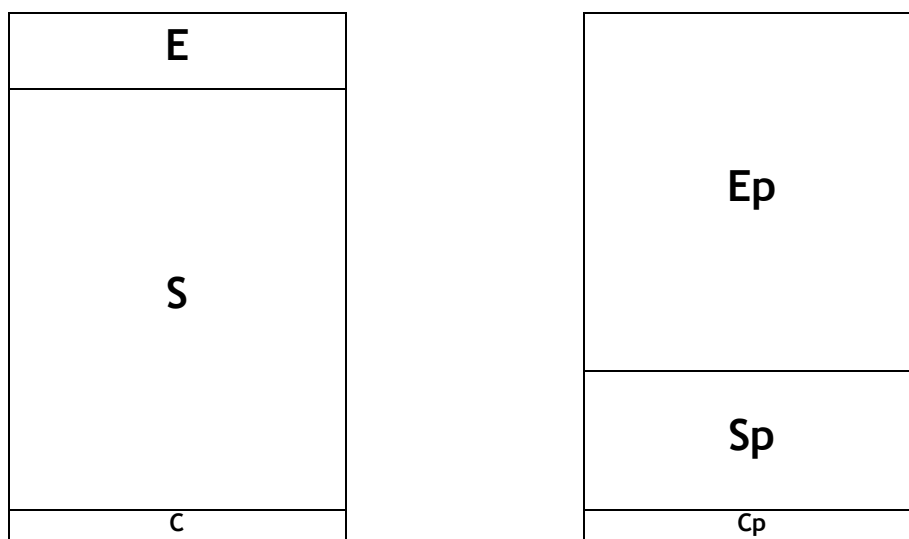
$$(HC_p + HE_p) > (HC + HE)$$

$$(WC_p + WE_p) > (WC + WE)$$

Or to put this another way, the amount paid as dividends to the husband and wife are both greater than can be justified by the underlying economic activity. This is generally called salary substitution in taxation terms.

It should also be noted that there is also an abuse of the underlying economics by way of salary substitution even if the company has just one shareholder (as is legal) and that shareholder also generates the entire income of the company if the split between the returns to enterprise and capital in the form of dividends is inappropriately high compared to the underlying reward generated from the expenditure of labour effort. This is shown as follows (there being no need in this case for the terms H or W):

Diagram 4



In this case the fact that:

$$E_p > E$$

and

$$S > S_p$$

Both are clear signs that an artificial tax driven arrangement is in place. And that is true. If tax compliance is defined as paying the right amount of tax (but no more) in the right place at the right time where 'right' means that the economic substance of the transaction accords with the declaration made for taxation purposes then it is clear in this case that tax compliance is not occurring: tax avoidance is instead. In that case there is a need for action to curtail this situation on the part of the government.

Why this is important

It is stressed that none of these things would be important if:

1. Dividends and salaries were taxed in the same way and at the same tax rate in the UK;
2. All income was only taxed at one rate and the level of personal allowance was negligible;
3. There was no national insurance system;
4. Persons living in stable co-habiting relationships were taxed as a single family unit;
5. The government was indifferent to some in society being able to attribute the income they have earned to others who have not generated that economic well being without this opportunity being available to all taxpayers.

None of these conditions hold true in the UK economy:

- a. Dividends can be taxed at a lower rate than equivalent income (20% as compared to 22% at present, for example for those not subject to higher rate tax);
- b. The UK does have higher rate taxation with the intent of creating a progressive taxation contribution as income rises;
- c. National insurance contributions can be as high as tax paid when the employer's contribution is taken into account for a majority of employees in the UK, but there is no national insurance charge on dividend income;

- d. We have separate taxation (for most purposes) of those living in stable relationships, whether legally associated or not;
- e. The government does not approve of the diversion of income to those who have not earned it for taxation purposes, as a matter of policy.

It is important to stress that some of these are unlikely to be the subject of reconsideration as a part of this debate and as such are considered constraints in this discussion. In particular:

1. Progressive taxation is at the core of any just taxation system, matching the need of society with the ability to pay to meet that need. In addition, progressive taxation accords with all accepted principles of economic theory. As income rises the marginal utility of each pound of income falls. As a result a proper progressive tax system will mean that the effective marginal utility cost of tax paid is constant even though the proportion of each part of additional income earned might rise, at least until a certain level of income is reached when a plateau is likely.
2. Pragmatically a national insurance system broadens the tax base and is an effective means of funding pension obligations. Without abolishing state pension obligations an alternative is unlikely. Integration with tax is also unlikely for a number of reasons including resulting difficulties that would arise with the taxation of those of pensionable age who are not liable to make such contributions. None the less policy implications do arise from this which are mentioned later.
3. The operation of self assessment and PAYE is heavily dependent upon separate taxation (subject to constraints created by the tax credit system). In addition, taxing the family unit would give rise to as many problems as it might solve, especially if linked to marriage. Since marriage is more prevalent amongst those with higher income and family unit taxation would only be introduced if it reduced their tax bill such a move would only increase the gap between rich and poor in the UK, a gap that is already threatening social harmony.
4. It would be inappropriate for the government to allow those in self employment or quasi self employment (as the owners of private limited companies are) to divert their income to their partners as compensation for those person's contribution to household

management when the same option was not available to those in employment. Such a policy would be without any logical foundation: there is no reason to suggest that the burden of domestic responsibility is per se greater for the non-self employed partner when one of the couple is self employed than it need be in any other relationship. It is stressed though that nothing in this paper says that the partner who owns part of the self employed business but is not its driving force should not be compensated for the role they play in it: that would be quite unjust. It must be possible that they be paid, but only for the value they generate. There is however no credible argument for changing taxation policy so that they can be paid for non-business activity that they undertake with the overall consequence of reducing the taxation burden of the family unit in the circumstance that one partner was self employed, but no other.

Remaining parameters subject to consideration

This then leaves a situation where the number of parameters capable of alteration to resolve this issue has been markedly reduced. They come down to the following:

1. Changing the taxes that impact directly on this issue;
2. Changing tax rates;
3. Changing the way in which rewards may be distributed by a company;
4. Imposing rules on the allocation of profits within companies;
5. Changing the rules of incorporation.

Anything else has too broad an implication on the rest of the tax system to be considered viable given the scale of the issue being addressed.

The scale of the issue

The scale of this issue also needs to be considered. No one really knows how many companies are “income splitting” or paying dividends in excess of those justified by the return due to enterprise. What is clear is that there are savings by doing so. To illustrate this a number of tax calculations have been prepared using rates and bands for the tax year 2007-08 assuming a

consistent £50,000 of income available for the payment of reward to a single person supplying their services in a number of situations. These are:

1. A salary is paid direct to the person undertaking the work at a total cost of £50,000. This is an actual salary of £44,915 a year having allowed for employer's national insurance. The net salary available after employer's NIC of £5,085, employee's NIC of £3,361 and tax of £9,380 is £32,174 per annum. Total tax due is therefore £17,827.
2. As an alternative the person provides their services through a company. A salary of £6,000 is paid by that company. The company would wish to pay this to a director / shareholder to ensure that national insurance is paid on their account to preserve state pension and other rights. The resulting employer's national insurance cost is £102, the employees NIC cost is £88 and the income tax due would be £77.

Having used £6,102 of profit in this way the rest will be available for company purposes. Part will be used for admin costs of running a limited company structure. This is assumed to total £1,400 per annum. This leaves £42,498 of profit to tax, which at 20% will give a liability of £8,500.

It is assumed that all the profit is distributed to the shareholder. In that case an additional personal tax liability of £1,589 will be due on that sum.

Having taken all these factors into account the total tax due will be £10,356. The net retained earnings would in this scenario be £38,244.

3. A Limited Liability Partnership arrangement is an alternative. This effectively subjects the income to tax as if the participant were self employed whilst still offering the protection of limited liability. It is assumed costs of administration costs will be lower in this case at £1,200 per annum. This leaves taxable profit of £48,800. This gives rise to a tax liability of £13,557 in total made up of:
 - a. Income tax, £10,934;
 - b. Class 4 NIC of £2,509;
 - c. Class 2 NIC of £114.

The net income would be £35,243.

In summary, therefore, the tax due and net benefit received under each arrangement will be (using the assumptions noted as to utilisation of the £50,000 start sum):

| | Tax due | Net benefit received |
|-------------------|---------|-------------------------|
| Salaried employee | £17,827 | £32,174 |
| Limited company | £10,356 | £38,244 |
| LLP | £13,557 | £35,243 |

Income of £50,000 per person may be a little high on average for companies involved in this activity, but was of the approximate level enjoyed by each participant in the case of Jones v Garnett. The savings would be higher if income splitting had been allowed for in the above calculations rather than considering just one person.

The lowest estimate I have seen of the number of companies using income splitting arrangements is 30,000. I think a figure of at least 200,000 much more likely if the option of the individual using a salary substitution arrangement of this sort to split income inappropriately is also considered. That might be a tax loss of £6,000 per company or £1,200 million per annum. That is a not insignificant sum, and justifies action to correct the unfair advantage being supplied to these people; unfairness in this case resulting from the form of the tax charge not aligning with the economic substance or reality that is occurring in the limited company that is being taxed.

Objectives for change

Within these constraints there remain considerable options for change. It is, however, assumed that in pursuing that change the following objectives are to be fulfilled:

1. The practice of income splitting must be ended as far as possible;
2. The benefit derived from salary substitution must be removed as far as possible;

3. The achievement of these goals must not unduly increase the administrative burdens on business or HM Revenue & Customs;
4. It must remain attractive in tax terms to take the risk of creating a small business.

The fundamental obstacle

This range of objectives, when matched with the noted constraints appears to make this a difficult issue to resolve. On reflection there is, however, an obvious reason for this. It is that the limited company to which the current tax rules are applied is really not suited for the task it is being used for. This is because:

1. As noted above, the rewards to capital and enterprise must be paid together. Given that it is difficult to alter the ratio of shareholdings from year to year and that varying dividend rates (or dividend waivers, which achieve the same result) are considered inappropriate by HM Revenue & Customs, being indicative in their eyes of potential artificial tax planning (as they have often been) this capital structure is clearly inappropriate for use in a system where the possibility of paying differing reward levels in different years is required, as indicated by the judgements in the Arctic Systems case.
2. The concept of the limited company was created in the 19th century and assumed a division between the ownership and control of the company. That division does not exist in the companies under consideration. As such much of the regulation surrounding these entities is wholly inappropriate.
3. It is assumed that the employees of a limited company are distinct from the source of the companies capital, and both are distinct from its management. This is reflected in tax law, where for example charges arise on the use by an employee of the equipment owned by a company when that equipment is in fact paid for in the companies under consideration out of capital most likely provided by the person actually using it as an employee, and therefore paying a tax charge for the benefit of making use of equipment they have funded. There is very limited economic logic to this: on this occasion netting off is the correct economic, accounting and taxation treatment. It is apparent though that the rules of the limited company and its taxation, which create a significant taxation border around the entity

at which a charge must be paid whenever it is crossed do not reflect economic reality in this case.

Other issues could be noted but these are sufficient to illustrate the point.

Reasons for incorporation

The reasons for using this inappropriate vehicle must therefore be noted. In doing so it should be borne in mind that the number of limited companies in the UK (now approximately 2.4 million based on latest Companies House data) has more than doubled over the last twenty years. Over 90% of these are classified as 'small'. This however does not mean all fall into the area of concern in this paper: most however will be owned by just one or two people, and in the majority of cases these people will probably be related meaning that some of the issues raised here might apply in the majority of these cases.

That said, it should also be noted that it remains the case that a substantial majority of small businesses are not run through limited companies. The number of small businesses can only be estimated since some do not declare their existence but based on recent discussions with HM Revenue & Customs a figure of around 4 million such enterprises might be estimated. Approximately half of those make tax declarations that they have a turnover (i.e. total sales) of less than £15,000 per annum.

This sets the context for deciding to use such an entity, the reasons for which are:

1. To secure guaranteed self employed status. Since it has become commonplace for HM Revenue & Customs to challenge the self employed status of many consultants their 'employers' have required that those persons provide their services through the medium of a limited company to ensure that there is a third party injected into the transaction that thereby separates the two and reduces the risk to the 'employer' of accounting for PAYE taxes that might otherwise be due. The existence of what are known as the IR35 laws provided additional incentive for 'employers' to require this by forcing the PAYE risk onto the contractor's limited company.
2. To secure tax advantages. As noted above, an individual artificially splitting gross income into a low salary and excessive dividend can

secure a tax advantage over both an employed person and a self-employed person seeking to utilise the same gross income to provide themselves with a net reward. This benefit is increased if part of the income is diverted from a person with a higher rate tax bill to a person with a standard rate tax liability, as income splitting between dual owners of companies usually achieves.

3. To secure limited liability. This is oft stated, but in practice of little apparent value to most limited companies. That this is so is indicated by the fact that over 95% of all limited companies that are removed from the Register of Companies are struck off and are not liquidated: they do not have liabilities that the owner required protection from at the end of the corporation's life. However, this does not deny that there is a an 'insurance' based rationale for using a limited company to secure protection from some insolvency risk. The fact that this risk is rarely avoided in the case of any borrowing does, however, also suggest that the protection is limited.
4. To secure an environment in which a partnership can be managed whilst allowing the property of each participant to be identified. This is important: when two people work together they wish for some protection from each other (whether or not they are related, marriages do fail and the stress of working together may increase that likelihood for some couples). A limited company provides a proven structure that gives this protection and identifiable and separate interests in the activity without the cost of creating a partnership deed, which may be many times the cost of incorporating a company.
5. To secure prestige. Some people believe that there is more status for themselves or their business if it is run as a limited company. The reason appears to be the illusion of substance that it provides. There is some logic to this. If half of all self employed people have turnover of less than £15,000, as their tax returns would imply, then having a company might suggest an operation more substantial than a typical small business.
6. Because accountants recommend the use of limited companies to their clients. This is an important, but little commented upon phenomenon. The annual accounting charges for running a limited company are probably twice those of assisting a client to run a business as a sole trader. The difference comprises charges for:

- a. Preparing accounts in statutory format;
- b. Preparing corporate as well as personal tax returns;
- c. Company secretarial services;
- d. Dividend planning services;
- e. PAYE services and preparation of declarations such as form P11D for benefits in kind;
- f. Auditing (if undertaken).

Accountants are self interested. The possibility that they recommend a trading medium that suits their purpose at least as much as it suits the needs of their client cannot be discounted.

Any alternative arrangement for the taxation of those seeking to run small businesses must also meet these needs.

Seeking solutions

It is unsurprising given this range of constraints and vested interests that debate on this issue is heated, and consequently not always constructive. As one commentator said following the House of Lords ruling on the Arctic Systems case “Given that this extraordinary case has baffled every court which has had the task of attempting to dissect it, the House of Lords have reached the only conclusion that is workable.”² This paper does not share that view. The Courts might have reached the only solution that was tenable within existing law: this paper assumes the law can be changed.

To be effective though any change in the law has to seek to positively promote the role of small business, fair taxation, reduced administrative burdens of enterprise and good management practice on the part of all participants in this process. This requires a solution that recognises the following:

1. There is a need for a corporate entity for smaller businesses that allows them to operate with a separate legal identity from that of their owners;
2. Within reason (i.e. in the absence of abuse) this entity should enjoy limited liability, as has now become customary;

² Nichola Ross Martin at <http://www.accountingweb.co.uk/cgi-bin/item.cgi?id=171041&d=1032&h=1019&f=1026&dateformat=%25o%20%25B%20%25Y/> accessed 6-8-07

3. That entity should be able to pay rewards for the capital, labour and enterprise supplied by some or all participants within it, with such reward being capable of variation from period to period without tax discrimination arising and with these rewards being treated as consistently as possible for tax purposes so that there is little or no incentive to misstate the payment made for taxation reasons;
4. The entity should be as straightforward as possible to manage and should have no greater, and preferably less administrative burden than current small limited companies;
5. For the sake of creditors of these entities transparency and accountability should be no less than that required of a small limited company.

A resolution - the LLP

It so happens that there is already in existence in the UK a legal entity that can provide the framework for solving this problem if appropriate incentives are given. This is the Limited Liability Partnership (LLP) which became available in the UK on 5 April 2001. There were 26,500 such entities in the UK in July 2007 according to Companies House, or 1% of the number of limited companies.

An LLP has the following characteristics:

1. It is legally distinct from its members;
2. It can own property and contract in its own name. This is important; for example the members of an LLP are protected from liability to their employees so long as they have acted in good faith. The self employed are not;
3. The members are only liable for the debts of the partnership if they have been reckless with regard to its management or have been personally responsible for its negligence. In other words, the partners can be protected from each other even when a partner might be exposed to claim from a third party;
4. There is no share capital in an LLP;

5. How profits are divided in an LLP is for the partners to decide so long as taxation law is not offended;
6. An LLP is transparent for taxation purposes i.e. the partners (or members as they are officially called) are charged to income tax on the profits attributed to them by the partnership and those profits are subject to Class 2 and Class 4 National Insurance as if the partners are self employed;
7. An LLP has to prepare accounts in similar form to and with the same requirement that they be placed on public file as is the case for a private limited company;
8. An LLP does, however face substantially fewer administrative burdens than a private limited company does:
 - a. PAYE need not be operated on payments to an owner for employment reward. In an LLP taking cash out of the business is not a taxable event;
 - b. An LLP cannot pay dividends, but nor does it need to do so: the whole administrative process is avoided as a result;
 - c. The members of an LLP cannot suffer 'benefit in kind' charges and as such the whole charging arrangements for these and expense reimbursements which adds considerably to the record keeping burden for the very small limited company is avoided;
 - d. An LLP has to be prepare a tax return but in doing so all the data for the member's own tax returns is prepared meaning that preparation of these tends to be much easier than the return for a director of a small limited company.

It is immediately apparent that:

- The requirement for a separate legal entity is met by an LLP;
- That entity has limited liability protection from the public, and as importantly, from other members;
- The administrative burdens of this structure are easier than for a company;
- The rewards paid by an LLP may be aligned with the underlying way in which the contribution is made by the member without tax

prejudice resulting. As a result some of the taxation inequalities shown to arise in diagrams 1 to 4 noted above can be addressed;

- The status of having a separate trading entity is achieved;
- An accountant still has a significant role to play in the operation of such an entity without burdening a client with unnecessary cost;
- Creditors are protected because accounting information has to be put on public record.

Problems to be solved

Immediately it can be seen that there are advantages arising from the use of such an entity. However, not all problems are solved:

1. It is not clear that an LLP overcomes the objection of a person engaging a consultant who wishes a legal entity to be placed between the two so that the 'IR35' risk with regard to failure to operate PAYE is transferred to the consultant's company;
2. There is tax risk in transferring a trade owned by a limited company to an LLP: a capital gains charge can arise in the company on the transfer to an LLP taking place even though the ultimate beneficial ownership has not changed. This is a major impediment to people switching from using limited companies to using LLPs;
3. A limited company cannot be re-registered as an LLP, instead the trade has to be transferred and bank accounts, all contracts and employments etc., all have to be transferred from one to the other, with considerable cost arising as a result. This is, again, a major obstacle to re-registration, especially as a stamp duty charge may also arise on the transaction;
4. The tax charge in an LLP can be higher than in an equivalent limited company because the profits of an LLP are subject to national insurance and dividends from a limited company are not when received by an individual. An LLP is, however, likely to have lower administration costs than a limited company and will still have a somewhat lower effective tax rate than would an individual taxed on the same gross sum if paid as a salary, as noted above. This does, however, still provide incentive to incorporate a company;

5. An LLP can be used for ‘income switching’: a partnership share can be attributed to someone with a low tax rate who has not worked for it.

Solving the issues

Each of these issues can be solved:

2. A statement by HM Revenue & Customs could make it clear that IR35 does apply to Limited Liability Partnerships (as is in fact the case). In that case it could be made clear that so long as the person engaging a consultant was not knowingly party to a tax avoidance arrangement from which they hoped to benefit then they might when making payment to an LLP be entitled to assume that any risk with regard to the operation of PAYE has been shifted to that entity and away from themselves. This would, it must be stressed also suit HM Revenue & Customs: the tax liability in an LLP always involves payment of some national insurance above quite low limits and this need not be the case with limited companies so they win from encouraging the arrangement whatever happens;
3. It should be made possible to re-register a private limited company as an LLP. This would not require a change in the nature of the entity: the old limited company would now assume LLP status. In that case there would, for example, be no need for the closing and re-opening of bank accounts or for the renegotiation of contracts or the assignment of the ownership of property: all would continue with the entity which would instead change its state. Membership of the LLP would have to be offered to all those previously members of the limited company and in the same proportion as before re-registration too place. Reserves would be attributed to members on the same basis with suitable anti-avoidance provisions being included in tax legislation but with intention to be used only when there was no apparent commercial justification for the re-registration. No tax charge should arise on re-registration except that reserves attributed to a member should be considered an income distribution at that time. This will be of only very limited concern to most smaller companies. Where that is not the case an option to spread the liability over a limited period of, say, three years should be made available to ease the burden on transition. The base cost of the shares in the company should be considered the base cost for acquiring the interest in the LLP for capital gains purposes. Any losses

within the company should be attributed to the members in ratio to their ownership to be offset only against future income arising from the LLP.

4. The incentive to register a limited company should be reduced. There are two ways to do this:
 - a. Increase the minimum required share capital. If set at a level of only £20,000 this would discourage the vast majority of small businesses from registering as a limited company and would reserve this form of company for the type of entity which requires to raise capital funding for the activity it undertakes. This makes commercial sense;
 - b. The distribution of dividends by limited companies should be subject to additional taxation in the hands of UK resident persons. For those who income split within limited companies in which there is just one member it is the avoidance of national insurance that provides them with their reward. It is too much to expect that national insurance will be merged into income tax: there are major obstacles to doing so including the resulting unfair tax obligations that will arise on many pensioners and the disadvantage that a high headline tax rate appears to have when managing the shadow economy. It is, however, possible to charge investment income to an additional tax as part of the overall income tax charge. This was done in the UK until 1984. Investment income for these purposes would be:
 - i. All dividends whether from companies or other incorporated saving vehicles and whether the origin is in the UK or not;
 - ii. All distributions from trusts bar those established for charitable purposes or for the disabled;
 - iii. All interest or its equivalent, including rolled up capital distributions;
 - iv. Rents receivable.

Investment income would not include any pension payment from a State or a recognised pension fund.

All persons above pensionable age would be exempt from the charge in its entirety.

To make such a charge both fair (in terms of comparability with national insurance) and to reduce its administrative burden it would be appropriate that an initial amount of investment income be exempted from the charge each year: a sum of £5,000 seems appropriate.

If the rate were set to be equivalent to the employee's national insurance charge then the incentive to incorporate would be dramatically reduced. Since the employer's national insurance charge is not capped nor should liability to this charge be capped either.

It is estimated, based on HMRC data, that this charge might raise a sum in excess of £3.8 billion per annum which is significantly more than the sum lost by income splitting. Allowing for recovery of part of the sum lost by income splitting as well it is likely that this charge might allow the reduction of the base rate of income tax by at least 1%.

5. Finally, the question that started the whole debate has to be answered: how is income splitting to be stopped since even with an LLP this can pay? It would seem that the issue is a tripartite one a three part solution is needed. The following is suggested:
 - a. That a rate of return may be paid on capital employed by the LLP on the partner's combined capital and current account. This should be a risk based return and so should be set at a reasonable interest rate of at least 10%. The balances used should be those at the start of an accounting year or the calculation becomes circular. This payment would count as investment income under the rules suggested here.
 - b. That a part of the income of any small business be attributable to management activity including administration. This might be 10% of turnover up to a turnover limit of £200,000 with a flat £20,000 being allowed for enterprises above that size unless they wish to argue their case for another sum. This sum can be allocated as the reward for enterprise to members as those members see fit so long as all members who participate in the

reward for labour effort expended receive a share of not less than $1/(1 + n)\%$ thereafter where n is the number of members. So, for example, where there are two partners only one of whom supplies services to clients and the turnover is £100,000 then £10,000 may be allocated to management activity, the partner supplying client services must receive £3,333 but the balance could be paid to another member without question being asked. That member could also get interest on their capital.

- c. The remaining reward shall be split in the ratio of the effort expended by those supplying services on behalf of the LLP to customers, or who can be shown to have a key role in doing so if not facing the supplier themselves. This is largely a matter of fact. In the Arctic Systems case it was obvious that only the husband had the necessary skills to supply the IT services that the company contracted to deliver. This will be so in the vast majority of such cases. If it is not then the LLP may put forward alternative argument as to why income should be allocated differently if it so wishes, with evidence being required to support the claim. This evidence will form part of the required books and records of the business. Guidance on how the partner delivering services to the client is to be determined would need to be issued. This might be best done by the use of a web site which would allow the input of data that would produce an acceptable profit sharing ratio based for example on:
 - i. Time expended;
 - ii. Evidence of management input e.g. attendance at meetings, client premises, emails sent, etc.;
 - iii. Evidence of key services supplied e.g. technical input, invoicing, project management, product sourcing, etc.

If no evidence can be supplied of a split in these categories (and many companies are very bad at keeping any form of audit trail of what they do) then the default position will be that all labour effort expended will be assumed to be undertaken by the partner most technically skilled to undertake the services the organisation has contracted to supply, so placing the onus of proof on the taxpayer.

It is not suggested that this technique will produce a perfect solution in every case: that is not possible. What it does do is produce an acceptable default position for situations where the partners /

members are related, turnover is relatively small (it is assumed that this model would not be used if turnover exceeded £200,000), the LLP supplies the services of one or more of its members in the main and at least one partner's role in the business is to supply support services relating primarily to management and administration matters.

Conclusions

This paper shows that there is a problem of 'income shifting' in small limited companies at this time that does result in tax avoidance. The payments made by these companies to those who participate in them might not reflect the economic rewards due to those participants based upon the real value of the inputs they supply to that company and as such the arrangements are not tax compliant, which is the test for acceptability used in this paper and increasingly commonly by HM Revenue & Customs.

The paper then shows that this problem of 'income shifting' within privately owned limited companies is probably insoluble within the existing constraints under which those companies are operated: they were not designed for the purpose for which they are being used and cannot be adapted to fit without compromising their use in those circumstances in which they have a role to play.

In that case it is argued that any solution to this issue requires:

5. A change in company law to allow the re-registration of small limited companies as LLPs;
6. The introduction of new capital requirements for the incorporation of limited companies, and over time forced re-registration of those that do not meet that standard as LLPs;
7. The introduction of a new investment income surcharge that would have the benefit of reducing the incentive to split income, restore the taxation balance between income earned from all sources and allow a reduction in the base rate of income tax without adding substantially to the burden of administration of taxpayers since those liable will, in the vast majority of cases, already be submitting tax returns;

8. Create new, economically justifiable and verifiable standards for splitting income in LLPs so that the risk of legal challenge to such arrangements will be substantially reduced whilst recognising the significant role that the partners of those who supply their services through owner managed corporate entities play in the undertaking of that activity.

If this were done then:

- h. The administrative burdens for many small businesses would be decreased;
- i. The certainty of the arrangements under which they can operate would be increased;
- j. The rewards that they rightly seek to pay to those who contribute to the management of these companies from within domestic relationships will be rewarded, but within appropriate constraints;
- k. The attraction of freelance status in tax terms would be retained;
- l. The current injustice that sees income from labour more heavily taxed in the UK than income from capital would be eliminated in large part without prejudicing the required favoured status of pensioners;
- m. The incentives for tax planning would be reduced, so simplifying tax administration;
- n. The tax yield might either rise, or a reduction in the tax rate might result.

The challenge in creating such a system is significant, but far from insurmountable. It is the challenge of creating an enterprise culture that meets the needs of the UK in the 21st century, and that is a challenge that any government needs to rise to.

About the author

Richard Murphy is a chartered accountant and economist. He trained with KPMG and was senior partner of a firm of accountants primarily serving the SME sector for 15 years. He has been chairman, chief executive or finance

director of ten SMEs. He writes and broadcasts regularly, is now director of Tax Research LLP and is an external Research Fellow at the Tax Research Institute, Nottingham University Business School and at the Centre for Global Political Economy at the University of Sussex.

Appendix 2

A Code of Conduct for Taxation

Published by the Tax Justice Network and the
Association for Accountancy and Business Affairs

Written by Richard Murphy of Tax Research LLP

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Objective

This Code of Conduct relates to the payment of taxes due to a State or other appropriate authority designated by it.

Scope

This Code applies to:

1. Governments and their agencies in their role as tax legislators, assessors and collectors;
2. Taxpayers, whether individuals, corporate bodies or otherwise;
3. Tax agents, whether they are undertaking tax planning or assisting with tax compliance.

Application

It is intended that this Code be voluntarily adopted by States and should be used to guide the conduct of taxpayers and their agents who choose to comply with it whether or not they reside in a State which has adopted the Code.

The Code

The Code is divided under six sections, each of which includes three statements of principle.

1. Government

- a. The intention of legislation is clear and a General Anti-Avoidance Principle ('Gantip') is in use;
- b. No incentives are offered to encourage the artificial relocation of international or interstate transactions;
- c. Full support is given to other countries and taxation authorities to assist the collection of tax due to them.

2. Accounting

- a. Transparent recording of the structure of all taxable entities is available on public record;
- b. The accounts of all material entities are available on public record;
- c. Taxable transactions are recorded where their economic benefit can be best determined to arise.

3. Planning

- a. Tax planning seeks to comply with the spirit as well as the letter of the law;
- b. Tax planning seeks to reflect the economic substance of the transactions undertaken;
- c. No steps are put into a transaction solely or mainly to secure a tax advantage.

4. Reporting

- a. Tax planning will be consistently disclosed to all tax authorities affected by it;
- b. Data on a transaction will be consistently reported to all tax authorities affected by it;
- c. Taxation reporting will reflect the whole economic substance and not just the form of transactions.

5. Management

- a. Taxpayers shall not suffer discrimination for reason of their race, ethnicity, nationality, national origin, gender, sexual orientation, disability, legal structure or taxation residence; and nor shall discrimination occur for reason of income, age, marital or family status unless social policy shall suggest it appropriate.
- b. All parties shall act in good faith at all times with regard to the management of taxation liabilities;
- c. Taxpayers will settle all obligations due by them at the time they are due for payment.

6. Accountability

- a. Governments shall publish budgets setting out their expenditure plans in advance of them being incurred, and they shall require parliamentary approval;
- b. Governments shall account on a regular and timely basis for the taxation revenues it has raised:
- c. Governments shall account for the expenditure of funds under its command on a regular and timely basis.

Enforcement

States seeking to comply with the Code will voluntarily submit themselves to annual appraisal of their Conduct. These appraisals will in turn be reviewed

by a committee of independent experts appointed by participating States. Differences of opinion will be resolved by binding arbitration.

Any taxpayer or agent wishing to comply with the Code may do so. A State should presume that a person professing compliance with the Code has done so when dealing with any tax return they submit. In consequence the administrative burdens imposed upon that person should be reduced. In the event of evidence of non-compliance being found any consequential penalty imposed should be doubled.