

INCOME SHIFTING & THE FAMILY BUSINESS

Income shifting is the concept of using another's tax allowances – commonly a spouse, but could be another family member, common law partner, civil partner, etc – to reduce your tax bill. We refer to spouse below for convenience but the comments hold good for other relationships.

The so called “husband and wife company, where one partner to the marriage produces all, or most of the income, but salaries and dividends are distributed 50:50 has historically been quite common, and until recently treated benignly by the tax system.

Around 3 years ago HMRC started to challenge such arrangements using the then Section 660a Settlements Legislation – the details of this legislation aren't really relevant, but suffice to say it had been on the statute book since just after World War 1, and some felt it was a little unfair for HMRC to suddenly start to enforce it in a different way after 70 years!

A test case, Arctic systems, went through the courts and after early victories to HMRC, the final two appeals were won by the taxpayer.

This means that as the law currently stands using spouse allowances is legal to reduce tax bills. This means if you have a non working spouse, or one who earns less than £40,000 pa (the Higher Rate tax threshold), and you are likely to be a Higher Rate taxpayer (salary and gross dividends in excess of £40,000) then it makes sense to include your spouse as a shareholder and let him or her have a share of your dividends.

In the wake of the last court defeat the Government committed itself to legislation to prevent the above, so called “Income Shifting” legislation.

This was to apply from 5 April 2008, but has been deferred to 5 April 2009.

To that end the advice above holds true till April 2009, but from then onwards shareholdings will need to broadly reflect the respective contributions of each person to the business. In the context contribution could be time, knowledge, contacts, finance or other resources.

The new rules, if they are enacted as currently proposed, will catch a situation where an individual controls the distribution of income, as salary or dividends, from a company or partnership, and causes it to be paid to another party in a proportion which is unequal to their contribution to the business. This will catch the classic stay at home spouse situation.

Businesses where all shareholders / partners are equally involved should have no cause for concern.

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