

# Income Shifting and Arctic Systems

## A review of the current position Autumn 2009

Following the victory in the high court by the taxpayers in the Arctic Systems case, a backlash was expected from the government. That was partially realised by the Chancellor's proposed new rules announced on 9<sup>th</sup> October 2008 to prevent income shifting. However these rules have now been indefinitely postponed. The history of this issue is detailed below:

### Background

The settlement legislation can now be found at s619 Income Tax (Trading and Other Income) Act 2005 [previously s660A ICTA 1988].

The legislation is designed to prevent a person diverting their income to another person who is a lower rate taxpayer. Typically this will apply to married couples (and registered Civil Partnerships from 5.12.05) where the income of the couple is re-distributed without

diminishing the income of the household. The only effect is to reduce the tax liability. However it is not actually restricted in its application to married couples and would apply equally to other arrangements.

The effect of the legislation is to put the income back to the person who earned it and tax it on them rather than on the other person to whom it has been diverted.



### What is the Arctic Systems case about?



This case concerned a Mr & Mrs Jones. Mr Jones created the profit in the company and worked full time. Mrs Jones carried out a few administrative functions and worked about 4 or 5 hours a week.

Mr Jones did not take a commercial salary for his work for the company so the profit in the company was much higher than would otherwise be the case. Mr & Mrs Jones each own half the shares in the company. A dividend was declared to distribute most of the profit in the company and this was therefore paid equally to Mr & Mrs Jones.

By setting up the company in this way it is argued by HMRC that Mr Jones has diverted part of his income to Mrs Jones and is caught by the settlement legislation.

## Current Proposals For New Income Shifting Rules in Brief

The current proposals for the new rules will seek to restrict the use of the personal allowance and basic rate tax bands for individuals, where one individual receives income from a company/or partnership and makes little or no economic contribution.

In these circumstances where the individual makes little or no economic contribution to the company or partnership and yet still receives a significant dividend or share of partnership profits, the new rules will re-allocate the income received to the other individual making the significant economic contribution and tax it as if it arose to that individual originally. This may result in higher rate tax falling due at 40% when income is reallocated rather than the basic rate tax at 20% (or effectively 0% on dividends).

On the introduction of the new rules, the payment of dividends and partnership profit shares will have to be monitored to ensure that the individuals receiving the income make an economic contribution to the business in line with the reward that they receive, ie the dividend payment or partnership share should be on a genuine commercial basis, rather than designed to use up the relevant personal allowance and basic rate tax band.



## Timetable For Introduction Of New Rules



gained from applying them.

The initial proposals were aimed at introducing the new rules from 6<sup>th</sup> April 2008, making them applicable to the current 2008/09 tax year. The delay in their introduction highlights the concern felt by HM Revenue & Customs over how the rules would be policed and whether enforcing them will actually consume more time and resources than the increased tax take to be

included in the Budget Press Notices “The Government now intends to introduce legislation through Finance Bill 2009 and will not enact legislation effective from 6<sup>th</sup> April 2008”. However the budget 2009 and Finance Act 2009 did not introduce these measures which the Government says have been ‘postponed’ with no proposed date for enacting the proposals.

Although the enactment of the income shifting rules appears to have been “put on ice”, it’s worth remembering that HM Revenue & Customs have previously enacted legislation that has applied retrospectively. Bearing this in mind, our advice to all companies and partnerships is to carry on as normal for the moment, but to watch this space for further developments, particularly as we are unsure whether the proposals will be enacted in their current form.

It is this concern that led the Chancellor to delay the introduction of the new rules in this year’s Budget with the following statement

## For further advice and assistance

Monahans can assist you in assessing your position and help you plan to reduce your risk.

Please get in touch with your usual manager or partner or **Dominic Bourquin** on **01225 472800** or by e-mail on **dominicb2@monahans.co.uk**