

## Income shifting - guide for contractors

1. What "income shifting" means.
2. Where it comes from.
3. How it is supposed to work.
4. Why it won't work.
5. What it means to small business.

"[Income shifting](#)" is a term coined by the Treasury with the objective of getting contractors, and other small businesses, to pay more tax on company profit.

The idea is based on the notion that at many family companies one spouse does all the work and the other spouse doesn't. But husband and wife (or whichever partners share the company) pay taxes individually. So the partner who does all the earning supposedly 'shifts' half the income to the partner who does nothing, and both partners pay less combined personal tax as a result.

### Based On Dividend Division

All of this is based on the fact that at such companies most income is taken in the form of [dividends](#) and not salary which is taxed at the source. This strategy of [dividing up the dividend income](#) is one that has been accepted as legitimate since World War II -- it is only the current Government, which seems to have a real antipathy to small business in general and contractors in particular, which is taking steps to restrict it.

All businesses employ various tax strategies to limit their liability, and there is nothing wrong with employing such strategies so long as they remain on the right side of the law. Dividing up dividend income in this way has been, in fact, so entirely respectable, that the Ministry for Business and Enterprise actually had a recommendation on its website that small companies do this, until the Treasury decided to take action.

### Revenge For Arctic Systems

Unfortunately, the first action taken by the Treasury proved to be cruel and unusual punishment. HMRC attacked a small family business called Arctic Systems and tried to force the couple who owned it to pay back taxes on the basis that income was being 'shifted' from the principal earner, a computer consultant, to the spouse who ran the business and kept the books. The theory was that the computer consultant was the only real earner. HMRC dragged the couple through the courts for six years until finally the [Law Lords ruled against HMRC](#) in 2007.

### Treasury Proposal Ridiculed

Immediately after the court case was lost, Labour's junior Treasury minister Angela Eagle [announced](#) that changes would be made in the law so that "income shifting" could be penalised. The Government [announced its proposed law](#) with the Budget this year, and the bill, as it was elaborated by the Treasury, was received with ridicule--there is no other word for it--by every tax expert and tax organisation in the country. It has been called "unworkable," "badly drafted," "impossible to implement" by organisations like the [Chartered Institute of Taxation](#) and the [Institute for Chartered Accountants](#). Despite the ridicule and outcry the Government has suffered from the proposal, they intend to put it through.

### So How's It Supposed To Work?

So, how does this all work for the typical family company that the Government is targeting?

Let's say a couple--husband and wife for example, but it could be any two partners-- forms a company, and each owns 50% of the shares. The company provides consultancy services, perhaps in IT or engineering for example. Let's say the husband goes out into the field and provides the consultancy work, while the wife works in the business doing all the admin work, answering phones, and general other background tasks to make it possible for the husband to do the consulting.

Business goes well. They each take a small salary, and after expenses, they're left with a profit. This profit is subject to corporation tax, leaving a net profit which can be distributed as dividends to the shareholders.

So husband and wife each takes half the net profit as a dividend. Both husband and wife must then pay tax on their personal income. Now, those dividends are subject to further tax only if the amount the person earns takes them over the higher earnings tax limit - currently around 34,000 pounds per year. So, any profits below 68,000 pounds are not taxed further, because the money is split between the two partners and so keeps each one under the 34,000-pound threshold.

“ The income shifting proposal has been received with ridicule by every tax organisation in the country ”

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## Says the Treasury: The Wife Contributes Nothing!

Now, let's suppose that the wife were not a shareholder. This would mean the husband takes all the dividends, and then has to pay further tax on them.

The Treasury claims that the wife isn't really 'adding value' to the business, and so has no right to receive dividends. What the new legislation proposes is that the small business owners will have to "prove" that the supposed non-earner adds enough value to the business to merit the dividend payment. What, asks the Treasury, would be the value of the wife's services if they were paid for on the open market, that is, if the company had to hire someone else to perform them?

### Why It Won't Work

As one tax expert after another has shown, providing a value for the wife's services is practically impossible-- the technical term for such a valuation is an "arms-length" value.

It is painfully clear that, in a family business, each partner contributes a great deal more than what can be shown on a paper valuation. The wife, in our example, may help make sales when answering calls, or may provide practical advice, help build a network of contacts, help when clients call up with issues to be resolved and the husband isn't there.

### "Arms-length Valuation Isn't Possible!"

The example given by many experts is the family farm, where, at one time or another, husband, wife, children, and even aunts and uncles all pitch in to keep the place going. How do you put a value on that?

### What It Means to Small Business

The Government has refused throughout the consultation period to modify or clarify the proposal sufficiently. The result is that thousands of small businesses will have difficulty in managing their taxes. Worse, an additional burden of administration and paperwork has been placed on the shoulders of contractors and family companies of all kinds.

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“ Take the example of the family farm where husband and wife and children and even aunts and uncles all pitch in to keep the place going so how do you put a value on that ”

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