

Summary: Intervention & Options

Department /Agency:
**HM Treasury and HM
Revenue & Customs**

Title:
**Impact Assessment of draft legislation to address
income shifting**

Stage: Consultation

Version: One

Date: November 2007

Related Publications: Income shifting: a consultation on draft legislation

Available to view or download at:

<http://www.hmrc.gov.uk/better-regulation/ia.htm>

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What is the problem under consideration? Why is government intervention necessary?

The Government believes that an individual should pay tax on income that is attributable to them. Income shifting occurs when an individual redirects part of their income to a second individual who is subject to a lower rate of tax, so that the shifted income is subject to less tax. The Government believes that there are unfair outcomes when individuals can shift their income because of personal choices that they have made. The Jones v Garnett case has highlighted the need for new legislation to provide clarity for business regarding the Government's position.

What are the policy objectives and the intended effects?

The new legislation should prevent individuals gaining a tax advantage from income shifting through company and partnership distributions. It is not the intention that businesses will change their remuneration structure as a result of the legislation, but rather that any tax advantage derived from non-commercial structures is negated.

The Government estimates that this would reduce the tax lost through income shifting by £200m and protect further tax loss of £350m by 2010-2011.

What policy options have been considered? Please justify any preferred option.

1. Do nothing.
2. Amendments to existing legislation.
3. Provide new legislation: This would prevent individuals from gaining a tax advantage through income shifting. Furthermore, it would provide clarity on the Government's position, enabling individuals who were shifting their income to plan for the future.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

4 years (after receipt of the first self-assessment returns concerned, which will be 2010).

Ministerial Sign-off For consultation stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister:



..... Date: November 2007

Summary: Analysis & Evidence

Policy Option: 3

Description: Provide new legislation

COSTS	ANNUAL COSTS		Description and scale of key monetised costs by 'main affected groups' - Small companies and partnerships where income shifting strategies are being followed could incur one-off transitional costs through needing additional professional advice. This may include some business reorganisation, for example removing shareholders, directors or partners.
	One-off (Transition)	Yrs	
	£ TBC		
	Average Annual Cost (excluding one-off)		
	£ 0		Total Cost (PV) £
Other key non-monetised costs by 'main affected groups' - Agents will need to familiarise themselves with the new legislation to advise both businesses where income shifting occurs and businesses where remuneration patterns look similar to income shifting.			

BENEFITS	ANNUAL BENEFITS		Description and scale of key monetised benefits by 'main affected groups' - At the margin, some partnerships established to enable income shifting will revert to sole trader status. Companies set up in part to enable income shifting are unlikely to dissolve. The legislation is expected to yield revenue of £25m in 2008-09, £260m in 2009-10 and £200m annually thereafter.
	One-off	Yrs	
	£ TBC		
	Average Annual Benefit (excluding one-off)		
	£ 0-200,000		Total Benefit (PV) £
Other key non-monetised benefits by 'main affected groups' - Taxpayers in general will benefit from those who formerly shifted their income bearing the tax burden applicable to their income.			

Key Assumptions/Sensitivities/Risks

The overall scale of income shifting activity and the behavioural response to the legislation among small businesses is difficult to gauge accurately.

Price Base Year 2007	Time Period Years	Net Benefit Range (NPV) £	NET BENEFIT (NPV Best estimate) £
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What is the geographic coverage of the policy/option?		UK wide		
On what date will the policy be implemented?		5 April 2008		
Which organisation(s) will enforce the policy?		HMRC		
What is the total annual cost of enforcement for these organisations?		£ Negligible		
Does enforcement comply with Hampton principles?		Yes		
Will implementation go beyond minimum EU requirements?		N/A		
What is the value of the proposed offsetting measure per year?		£ N/A		
What is the value of changes in greenhouse gas emissions?		£ N/A		
Will the proposal have a significant impact on competition?		No		
Annual cost (£-£) per organisation (excluding one-off)	Micro	Small	Medium	Large
Are any of these organisations exempt?	No	No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices)		(Increase - Decrease)	
Increase of £ 0	Decrease of £ 0-200,000	Net Impact	£ 200,000 decrease

Key:

Annual costs and benefits: Constant Prices

(Net) Present Value

Evidence Base (for summary sheets)

Background

The Government announced in the 2007 Pre-Budget Report that it would be taking action to counteract the tax advantage gained from income shifting through partnerships and companies. The Government believes that the use of non-commercial arrangements to gain a tax advantage through income shifting creates an unfair advantage when compared with the majority of individuals who cannot or do not shift their income.

The Government is keen to provide legislation that will prevent a tax advantage being gained while ensuring that any administrative burdens are kept to a minimum. The Government believes that the legislation should provide businesses with a clear statement on the Government's position.

Further explanation of the policy options

Option 1: Do nothing

Benefits: Keeping the status quo would provide an opportunity to continue gathering further information on the extent of income shifting.

Costs: The current losses of income tax are likely to increase, leaving those who do not shift their tax burden paying a disproportionate share of tax. Moderate estimates have been provided given the complexities of measuring the numbers of businesses involved, but it is assumed that the number of businesses that would engage in income shifting could increase following the loss of the Jones v Garnett case. This is an unacceptable risk to the Exchequer.

Option 2: Amendments to existing settlements legislation

Benefits: It is preferable to make existing legislation work where possible, as this allows a quicker response than introducing new measures and may not place new compliance costs on business.

Costs: The Government does not believe that amending the existing settlements legislation would be sufficient to prevent income shifting. Furthermore, where the legislation could be amended, it would be unclear whether it would set out the Government's position clearly for business. It is expected that a significant additional HM Revenue & Customs (HMRC) resource would be required, drawing resources from other compliance work.

Option 3: New legislation specifically written to address income shifting

Benefits: A new piece of legislation could be written to reduce potential unintended consequences. It would provide a clear statement of Government intent and specifically address current forms of income shifting.

Costs: New legislation would not necessarily have the support of existing case law or guidance. For it to be successful the legislation would have to be workable and HMRC would have to provide clear guidance on its practical applications.

The consultation

The Government believes that it should provide a clear statement of its position in order to provide clarity and consistency for businesses. A new piece of legislation specifically written to address income shifting (option 3) would, in the Government's opinion, do this best. The Government is not consulting on the options available, but recognises that, for the legislation to be effective, it must achieve its primary objective while minimising other consequences. The Government would therefore welcome comments on how this can be achieved and, specifically, how the draft legislation and guidance within the consultation document can be improved to achieve this.

Predicted impacts of Option 3: Provide New Legislation

Impacts on business

Revenue Yield

The yield is based on the effect of clearer, more effective legislation, which clarifies the Government's position on income shifting.

For impact assessment purposes, yield is treated as a transfer cost rather than a cost or benefit. The yield from this measure is estimated based on assumptions of certain behaviours. The Government accepts that these assumptions may, at times, be imprecise. However, the nature of income shifting requires measurement to be made in this way.

Analysis of the data has identified 65,000 companies where income shifting is likely to be taking place. Based on the income levels and dividend strategies used, the current losses from income shifting in companies are estimated at £350 million per year. In addition it is estimated that some 20,000 two person partnerships are displaying signs of income shifting, incurring losses to the Exchequer of up to £150 million per year. The total loss to the Exchequer is estimated at around £500 million per year and would be expected to grow in the future in the absence of action. The proposals put forward will have the benefit of preventing this Exchequer loss from escalating.

The figures relating to the tax gap from income shifting necessarily consider 100% of the income concerned to be shifted income. However, the Government recognises that often this is not the case, with both individuals playing a role in the business that may warrant remuneration. The estimates of additional yield take this into account and are therefore lower than the tax gap figures. HMRC will expect all businesses to comply with the new legislation wherever it may apply. The estimated yield to the Exchequer of option 3 is £25 million in 2008-2009, £260 million in 2009-2010 and £200 million in subsequent years.

HMRC will develop a compliance strategy in line with any legislation to ensure its effectiveness. However, as with all legislation, the Government is looking to individuals to comply voluntarily without the need for interventions. To ensure this is possible, the Government would welcome comments on any improvements that could be made to the draft legislation or guidance to make this easier.

Removing Inequity

There are further benefits from eliminating the unfair advantage received by those paying levels of tax less than is applicable to their income. This is laid out in greater detail in the Competition Impact test.

Administrative Burden

A minority of partnerships that cease income shifting are likely to revert to sole trader form and therefore cease to submit partnership returns. From analysis undertaken by HMRC using the standard cost model, if 1,000 partnerships change status to become a sole trader, the administrative burden saving is estimated at £200,000 per year. However, it is not clear how many partnerships will change their status.

The Government currently does not believe that there will be a decreased administrative burden on existing companies, as it is unlikely that those companies currently income shifting will dissolve purely on the basis of the legislation. If any individuals did dissolve their companies to revert to sole trader form, it is estimated that they also would reduce their administrative burden.

Transitional Costs

All those business who are income shifting will face a one off cost in assessing the impact of the legislation. This may mean they are required to seek guidance from their accountant or financial planner and to take action in order to ensure they become compliant, or familiarise themselves

with any new legislation. Around 80 per cent of partnerships and 50 per cent of the smallest companies use an agent. The transitional cost of taxpayers seeking advice from an agent is to be confirmed.

The remainder of individuals who shift their income and do not have an agent would, however, still be subject to transitional costs. This would include familiarisation with the new legislation etc. The cost of this has not been calculated given the wide range of factors and significant difficulty in measuring them. However, the Government would welcome feedback on the expected costs in response to the consultation.

Unintended Consequences:

1. The draft legislation may encourage some individuals to exploit other methods of reducing their tax liability.
2. Individuals who genuinely pay the right levels of tax but whose businesses are structured in such a way that they may look like those who shift their income may be picked up by risk assessment in HMRC's compliance strategy.

HMRC costs

HMRC would incur additional administrative costs of enforcing compliance with the draft legislation. HMRC would need to develop guidance for compliance staff to enable them to risk assess and challenge non-compliant individuals. However, these would be relatively minor costs and, hence, are not monetised. HMRC would keep its compliance strategy under review to ensure that resources would be made available where necessary.

Sectors & Groups affected

The greatest incidence of income shifting appears to be in micro businesses and the measures would particularly affect this group. This legislation applies to all business regardless of the individuals' demographics and is designed to make the tax system fairer and more equitable.

Small Firms Impact Test

The income shifting legislation would potentially affect all business, including small business. The evidence thus far suggests that the majority of those shifting their income are from small, possibly family-run businesses. It is therefore logical to assume that the draft legislation may have a disproportionate impact on small businesses relative to large business. However, this would be due to their use of income shifting, not because of their size.

Competition Impact Test

Applying the Office for Fair Trading competition filter to the affected sectors to assess the impact of the proposed measure, it was found that an in depth competition assessment is not warranted because the estimated impacts on competition are not significant. It is, however, anticipated that taking action against those currently shifting their income would, if anything, have a favourable impact on competition, as those currently shifting their income would, following application of the legislation, pay the same levels of income tax as those in similar circumstances who have not shifted their income. Income shifting could have led to these individuals gaining an unfair advantage over those paying the correct level of tax. The proposed legislation should help remove this unfair advantage.

Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.

Type of testing undertaken	<i>Results in Evidence Base?</i>	<i>Results annexed?</i>
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	No	No
Sustainable Development	No	No
Carbon Assessment	No	No
Other Environment	No	No
Health Impact Assessment	No	No
Race Equality	No	No
Disability Equality	No	No
Gender Equality	No	No
Human Rights	No	No
Rural Proofing	No	No