

**INCOME SPLITTING, SETTLEMENTS AND AVOIDANCE:  
TAXING THE FAMILY ON BUSINESS PROFITS**

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## **ABSTRACT**

In a progressive income tax system with an individual tax unit, high-rate taxpayers have an incentive to split income with lower-rate family members to minimise the family's total tax burden. This raises equity and neutrality concerns. Adopting a spousal tax unit limits the gains from income splitting, but the individual is the better choice on privacy, autonomy, equality, definitional, marriage neutrality and work incentive grounds. Once the individual is chosen as the income tax unit, the control model provides a strong policy basis for attributing both earned and unearned income to individuals. Income splitting, however, undermines this model as well as the individual tax unit.

This thesis focuses on the UK's approach to income-splitting in family businesses. The relevant UK income tax rules, particularly the settlements provisions, are inadequate for the task. Various possible reforms are examined. Incorporating a transfer pricing or 'reasonableness' test into the settlements provisions would strengthen these rules, but would make taxpayer compliance with an uncertain regime even more difficult. Another option is to expand the scope of employment tax by moving the borderline between employees and the self-employed or companies. Deeper structural reforms could be made to enhance the neutrality of taxation on different legal forms of economic activity. This would reduce the incentives to incorporate for tax savings, including from income splitting. Integration of income tax and NICs is one such option; a dual income tax is another. A TAAR or GAAR also could be pursued. Ultimately, some combination of these various reform options could provide a partial solution to this challenging issue.

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Finance Act 2005 ss 10-11

Income Tax (Trading and Other Income) Act 2005 (ITTOIA) ss 34, 620-629, 850

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## CHAPTER ONE: INTRODUCTION

This thesis examines the concept of income splitting for tax purposes in the context of the family businesses.<sup>1</sup> In an income tax system that adopts the individual as the tax unit and has a progressive marginal rate structure (or a flat rate combined with a tax-free personal allowance), there will be an incentive to ‘shift’ or ‘split’ income from a high-rate paying family member to a low- (or no-) rate paying family member solely to minimise the family’s total tax burden. This raises horizontal and vertical equity as well as economic neutrality concerns, and risks bringing the tax system into disrepute if some families, especially well-off and well-advised ones with business or unearned income, are able to rearrange their affairs purely to minimise taxes while other similarly-situated families cannot or do not.

The tax policy issues raised by income splitting within the family are not unique to any one taxing jurisdiction, but this thesis focuses primarily on the UK. In recent years the UK tax authorities have expressed particular concern over income-splitting arrangements involving family businesses making this issue highly topical. In November 2004 the Inland Revenue published a guide on the application of anti-avoidance legislation known as the settlements provisions now in Part 5 Chapter 5 of ITTOIA to

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<sup>1</sup> A cautionary note on terminology: economists sometimes use the terms ‘income shifting’ or ‘income splitting’ in a different sense, eg to describe the conversion of labour income into capital income or the shifting of profits from one country to another. In this thesis ‘income shifting’ and ‘income splitting’ are used interchangeably and refer to an individual diverting his or her income to another (related) individual to reduce the tax otherwise payable on that income.

these arrangements.<sup>2</sup> While the Revenue asserted that their position had been in place since the early 1990s, their pronouncements were met with considerable surprise and opposition from the tax community. More recently, in the 2008 Budget Report the Government stated:<sup>3</sup>

‘The Government firmly believes it is unfair that some individuals can arrange their affairs to gain a tax advantage by shifting part of their income to another person who is subject to a lower rate of tax.’

Notwithstanding the UK Government’s evident concerns, coupled with a taxpayer victory in the House of Lords in the family business income-splitting case *Jones v Garnett*,<sup>4</sup> the UK tax authorities have as yet been unable to devise an appropriate response to this issue. In the November 2008 Pre-Budget Report the UK Government reiterated its concerns that such income splitting was unfair, but backed away from its plans to introduce legislation in Finance Act 2009 addressing the issue, citing the poor economic climate.<sup>5</sup> The Government warned, however, that it is merely ‘deferring action’ and ‘will keep this issue under review’.<sup>6</sup>

The income-splitting issue has taken on even greater significance in the UK following tax rate rises announced in the Budget 2009.<sup>7</sup> From April 2010, the top

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<sup>2</sup> Inland Revenue, ‘A Guide to the Settlements Legislation for Small Business Advisors’ (November 2004) <[http://www.hmrc.gov.uk/practitioners/guide\\_sba.pdf](http://www.hmrc.gov.uk/practitioners/guide_sba.pdf)> accessed 18 May 2009 (Settlements Guide). The settlements provisions are discussed in detail in Chapter 5; see text beginning at n 655.

<sup>3</sup> HM Treasury, ‘Budget 2008’ (HC 388, 2008) [4.69].

<sup>4</sup> [2007] UKHL 35. This case is examined in detail in Chapter 5; see text at n 713.

<sup>5</sup> HM Treasury, ‘Pre-Budget Report November 2008’ (Cm 7484, 2008) [5.103].

<sup>6</sup> HM Treasury, ‘Pre-Budget Report November 2008’ (n 5) [5.103].

<sup>7</sup> HM Treasury, ‘Budget 2009’ (HC 407, 2009) [5.88].

marginal personal income tax rate is set to rise from 40% to 50% on income over £150,000. In addition, those taxpayers with income between £100,000 and approximately £113,000 will face a 60% marginal tax rate on that income from the withdrawal of personal allowances. A taxpayer earning £200,000 will be £7,590 worse off from April 2010; however, a dual-income couple earning £100,000 each will be no better or no worse off.<sup>8</sup> As a result of these measures, UK families will have an even greater incentive than before to seek tax savings from income-splitting arrangements.<sup>9</sup> Despite these incentives, in a post-Budget 2009 interview for a national newspaper HMRC stated merely that the issue of income splitting was still under review.<sup>10</sup> A tax commentator interviewed by the newspaper was more sceptical, stating that the government simply cannot work out how to deal with these arrangements.<sup>11</sup>

The central goal of this thesis is to develop a practical and comprehensive UK response to this issue, having regard to the broader policy issues raised and the approaches adopted in other jurisdictions. Income-splitting arrangements involving

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<sup>8</sup> Mike Warburton of Grant Thornton, interviewed in Elizabeth Colman, 'Ten Ways to Survive High-tax Britain' *Sunday Times* (London 26 April 2009) Section 5, 5. Warburton described Budget 2009 as the 'take your spouse back to work budget' and suggested another option for those homes with a sole breadwinner was 'to make sure you and your wife own shares and split the dividends equally'.

<sup>9</sup> Setu Kamal, 'Income Splitting' (28 May 2009) 163 *Taxation* 527; Sharlene Goff, 'High Earners Left with Few Ways to Avoid 50% Tax' *Financial Times* (London 24 April 2009) <[http://www.ft.com/cms/s/2/d7758e5e-3100-11de-8196-00144feabdc0,dwp\\_uuid=ae2324c8-28fc-11de-bc5e-00144feabdc0.html](http://www.ft.com/cms/s/2/d7758e5e-3100-11de-8196-00144feabdc0,dwp_uuid=ae2324c8-28fc-11de-bc5e-00144feabdc0.html)> accessed 27 April 2009 ('Those hit by the new 50 per cent tax rate, for example, could reduce their income by handing assets such as share portfolios and properties to lower-earning spouses.'). Similar statements are found in David Budworth, 'How to Avoid the Chancellor's Income Tax and Pensions Trap' *The Times* (London 24 April 2009) <<http://www.timesonline.co.uk/tol/money/tax/article6163908.ece>> accessed 29 April 2009.

<sup>10</sup> HMRC told the *Sunday Times* newspaper that moves to stop income splitting continued to be 'kept under review': Elizabeth Colman, 'Send Your Spouse Back to Work, Urge Accountants' *Sunday Times* (London 26 April 2009) Section 5, 1.

<sup>11</sup> Chas Roy-Chowdhury of the accountants' body ACCA Global, interviewed in Colman (n 10).

family businesses—and possible measures to target them—seem deceptively simple at first glance; however, as the UK Government has discovered, it is in fact a complicated, multi-faceted problem that involves many aspects of the tax regime. A range of comparisons need to be drawn to assist in establishing the equity and efficiency considerations at stake, including the taxation of earned income versus unearned income, married versus unmarried couples, and employees versus unincorporated and incorporated businesses. While the focus of the thesis is on income-splitting arrangements involving family businesses, this issue also needs to be considered within the larger framework of the taxation of the family and income splitting generally. The broad scope of this issue necessitates an examination of literature from diverse disciplines, including family law, public finance economics, sociology, and specialist tax topics such as tax avoidance and transfer pricing.

The structure of the thesis is set out below.

## Tax Policy Framework

Chapter 2 develops a tax policy framework that can be used to analyse the income-splitting topic generally as well as to evaluate the specific legal issues and reforms considered later in this thesis in the context of family businesses. These principles of tax design are currently one focus of the Mirrlees Review being undertaken under the auspices of The Institute for Fiscal Studies.<sup>12</sup> This and subsequent Chapters of this thesis

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<sup>12</sup> James Mirrlees and others (eds), *Reforming the Tax System for the 21st Century: The Mirrlees Review* (The Institute for Fiscal Studies, London 2008)  
<<http://www.ifs.org.uk/mirrleesReview/about>> accessed 15 April 2009.

draw heavily on the research chapters, commentaries and special studies prepared for the Mirrlees Review, along with other well-regarded sources such as the 1966 Canadian Carter Commission and the 1978 Meade Committee Report,<sup>13</sup> in developing a solid, modern policy framework for examining income splitting generally and in family businesses in particular.

## Choice of Tax Unit

Chapter 3 advances a conceptual discussion of individual versus spousal or family taxation and the implications for equity, neutrality, certainty and administrative aspects of the tax system. Incentives for income splitting in the family are strongest when the tax unit is the individual rather than a familial tax unit. Consequently, choice of unit plays a fundamental role in determining the extent to which income splitting will take place.

In order to provide a focused context for the discussion of tax unit, the Chapter begins with a critical review of the history and current UK position on choice of tax unit. The UK and international tax literature on the tax unit are then examined against this backdrop in order to determine whether the individual has indeed proved to be the best choice for tax unit in the UK income tax (and capital gains tax) system. The analysis addresses arguments for and against the individual as tax unit based on considerations including horizontal equity, privacy & autonomy, work incentives, marriage neutrality and couples neutrality. Recent developments internationally in family law and human

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<sup>13</sup> Royal Commission on Taxation (Carter Commission), *Report of the Royal Commission on Taxation* (Queen's Printer, Ottawa 1966); James Meade (ed), *The Structure and Reform of Direct Taxation* (George Allen and Unwin, London 1978).

rights law are also considered. The Chapter concludes with an examination of a potential middle-ground alternative—transferable personal allowances.

## Income Attribution and Income Splitting

Once the tax unit has been decided, the next question becomes (1) how best to allocate income to each unit and (2) how to respond to tax-motivated attempts to shift income from one unit to another. Chapter 4 seeks to determine why and to what extent income splitting within the family is problematic from a tax policy perspective. This issue is examined in light of the tax policy framework developed in Chapter 2 and applied in Chapter 3, taking into account equity, efficiency, certainty and administrative ease considerations. Possible approaches to attributing income to a tax unit, including the ‘benefit’ and ‘control’ models, are analysed. The Chapter also considers to what extent it is relevant whether the income to be split is earned (referred to by economists and in this thesis as ‘labour income’) versus unearned (referred to by economists and in this thesis as ‘capital income’). Alternative methods for arriving at an appropriate split in more complicated situations involving mixed unearned/capital and earned/labour income produced from the joint efforts of two or more family members are also evaluated.

## UK Approach to Income Splitting in the Family Business

Chapter 5 evaluates the UK tax system’s response to the inevitable income-splitting arrangements that arise from adopting the individual as the tax unit. The focus of the analysis is on the rules applicable to income-splitting arrangements involving family businesses, although other forms of income splitting are considered to some extent. First,

the limits UK tax law places on several basic forms of income-splitting arrangements, including paying salaries to spouses and children or sharing the business profits of an unincorporated partnership with partners who are family members, are examined. The Chapter then analyses the application of the settlements provisions to income-splitting arrangements involving family businesses.

## Options for Reform

Chapter 6 considers possible options for responding to the family business income-splitting challenge in the UK. Should the settlements provisions be modified to better combat husband and wife income-splitting arrangements? Substituting new specific anti-avoidance rules (such as those proposed by the Government in 2007) for the application of the settlements provisions in this context are another possibility, as are anti-avoidance rules. This Chapter considers all these alternatives, focusing in particular on the Government's abandoned proposals with a view to contributing to the ongoing consultation in this area.

More fundamental options for reforming the UK taxation of families on business profits to minimise the present income-splitting benefits also are examined. For example, should some component of distributed or even undistributed profits of family businesses be taxed as employment income instead of return on capital (which significantly restricts the scope for income splitting)? Further alignment of the income tax and national insurance contribution rules applicable to employees, unincorporated and incorporated

businesses may also reduce the incentives for small businesses to incorporate in search of tax savings, including savings from income splitting.

Chapter 7 provides a summary of the key arguments made in this thesis, and an overall conclusion on options for reforming the UK tax system to better address the tax policy concerns raised by the challenging issue of income splitting in family businesses.

## CHAPTER TWO: TAX POLICY FRAMEWORK

### A. INTRODUCTION

A great deal has been written recently in the UK on the subject of income splitting in the family business.<sup>14</sup> What has been missing from this debate, however, is a rigorous policy-based examination of the reasons why certain types of income-splitting arrangements are considered by some (but not all) to be problematic for the UK tax system whilst other income-splitting arrangements are deemed acceptable. Those opposed to income-splitting often justify their position by arguing such arrangements are unfair. One aim of this Chapter is to provide a comprehensive and thorough examination of what ‘fairness’ means in this context. Fairness also needs to be balanced against other tax policy criteria such as neutrality, certainty, and ease of administration.

Part B begins by examining the tax design criteria that will provide the policy framework for examining the tax unit (Chapter 3), income splitting generally and within family businesses in particular (Chapter 4), the UK’s response (Chapter 5) and possible options for reform (Chapter 6). These principles of tax design are one focus of the Mirrlees Review, which aims ‘to identify the characteristics of a good tax system for any open developed economy in the 21st century, to assess the extent to which the UK tax system conforms to these ideals, and to recommend how it might realistically be

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<sup>14</sup> The Westlaw citator on the key case of *Jones v Garnett* (decided by the House of Lords in 2007 and discussed at length in Chapter 5) lists over 10 pages of mainly practitioner-orientated journal articles discussing the decision (as of 20 March 2009).

reformed in that direction.’<sup>15</sup> This and subsequent Chapters of this thesis draw heavily on the research chapters, commentaries and special studies prepared for the Mirrlees Review in developing a sound and up-to-date policy framework for examining income splitting generally and involving family businesses in particular.

Part C concludes.

## **B. TAX DESIGN CRITERIA**

Tax policy commentators and theorists generally recognise that tax design must take into account a range of often conflicting factors. According to Adam Smith’s famous canons of taxation, taxes should be levied in accordance with ability to pay, be certain and not arbitrary, convenient to pay, and cheap to collect.<sup>16</sup> The 1978 Meade Committee Report<sup>17</sup> considered the desirable characteristics of a tax structure under six somewhat similar headings: incentives and economic efficiency, distributional effects (ie how the burden of the tax is to fall on particular individuals or groups and involving considerations such as the relative position of the rich and poor members of society), international aspects including compatibility with desirable international economic relations, simplicity and the costs of administration and compliance, flexibility and stability, and transitional

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<sup>15</sup> Mirrlees Review (n 12).

<sup>16</sup> Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Clarendon Press, Oxford: 1976) Book V, Chapter II, Part II ‘Of Taxes’ 825-28.

<sup>17</sup> Meade Report (n 13).

problems.<sup>18</sup> Public finance economists including Musgrave and Musgrave,<sup>19</sup> Boadway and Wildasin,<sup>20</sup> Sandford<sup>21</sup> and also Stiglitz<sup>22</sup> adopt a similar list.

Optimal tax theory, however, takes an entirely different approach to tax policy assessment, one that is grounded in welfare economics.<sup>23</sup> Relying on the pioneering work of Mirrlees,<sup>24</sup> proponents of this approach reject multiple objectives of tax policy in favour of a single objective—maximisation of a conventional social welfare function.<sup>25</sup> A given tax policy is assessed by first determining the effects of the policy on each individual's utility (sometimes referred to as well-being or welfare), and then aggregating these individual utilities under a social welfare function.<sup>26</sup> A tax policy is optimal if there is no change in it that will leave total social welfare unchanged and at the same time generate a net addition to government revenue.<sup>27</sup>

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<sup>18</sup> Meade Report (n 13) 7.

<sup>19</sup> Richard A Musgrave and Peggy B Musgrave, *Public Finance in Theory and Practice* (4<sup>th</sup> edn McGraw-Hill, New York 1984) 224-25.

<sup>20</sup> Robin W Boadway and David E Wildasin, *Public Sector Economics* (2<sup>nd</sup> edn Little, Brown and Company, Boston 1984) 226-27.

<sup>21</sup> Cedric Sandford, *Economics of Public Finance* (4<sup>th</sup> edn Pergamon Press, Oxford 1992) 111-17.

<sup>22</sup> Joseph E Stiglitz, *Economics of the Public Sector* (2<sup>nd</sup> edn W W Norton & Company, New York 1988) 390-408.

<sup>23</sup> For a legal academic's summary of optimal tax theory see John Tiley, *Revenue Law* (6<sup>th</sup> edn Hart Publishing, Oxford 2008) 14-15.

<sup>24</sup> See eg JA Mirrlees, 'An Exploration in the Theory of Optimum Income Taxation' (1971) 38 *Rev Econ Studies* 175, and JA Mirrlees, 'Optimal Tax Theory: A Synthesis' (1976) 6 *J of Pub Econ* 327.

<sup>25</sup> This formulation is taken from Louis Kaplow, *The Theory of Taxation and Public Economics* (Princeton University Press, Princeton 2008) 391-406 and 414.

<sup>26</sup> Kaplow (n 25) 37.

<sup>27</sup> Mirrlees (1976) (n 24) 354.

This thesis adopts the traditional multiple-objectives approach to tax design used by Smith, the Meade Committee and many other public economists. The criteria of good tax design are considered here under four main headings: equity, efficiency, certainty and administrative cost. The international considerations raised by the Meade Committee and others are of less significance in the context of income splitting within the family generally, and particularly within small family businesses. Certainty and administrative cost, on the other hand, are especially relevant considerations in this context. As will be seen, the optimal tax literature on taxation of the family generally, and income splitting in particular, is at present relatively sparse; however, optimal tax theory and other economic principles usefully contribute to some aspects of the debate, such as with respect to incentive effects and in the debate on the content and relevance of equity as a tax objective (discussed next).

## 1. EQUITY

Fairness or equity in tax design is difficult to define precisely, but is generally analysed as two distinct concepts—*horizontal equity* and *vertical equity*.<sup>28</sup> Horizontal equity requires that persons in the same situation pay the same amount of tax, whilst vertical equity requires that persons in different situations pay different levels of tax.<sup>29</sup> These two

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<sup>28</sup> Meade Report (n 13) 12; Carter Commission (n 13) Vol 1, 4; Boadway and Wildasin (n 20) 257; Sandford (n 21) 112; Stiglitz (n 22) 399.

<sup>29</sup> Meade Report (n 13) 12-14; Carter Commission (n 13) Vol 1, 4-5; Boadway and Wildasin (n 20) 257; Sandford (n 21) 112; Stiglitz (n 22) 399-401. The expression 'horizontal equity' is first attributed to Richard Musgrave: see Richard A Musgrave, *The Theory of Public Finance: A Study in Political Economy* (McGraw-Hill, New York 1959) 160 ('Perhaps the most widely accepted principle of equity in taxation is that people in equal positions should be treated equally. This principle of equality, or *horizontal equity*, is fundamental to the ability-to-pay approach, which

concepts are considered in more detail shortly. As Tiley observes, equity in tax is considered to be important both on the moral view that it is right and proper (like equality before the law is right), but also for the pragmatic reason that if a tax system is believed to be fair and equal, taxpayers will be more willing to co-operate with it.<sup>30</sup> Equity is also a central consideration for the UK Government as it formulates its response to income-splitting arrangements involving family businesses, as evident from the Budget 2008 quotation reproduced in the Introduction to this thesis.<sup>31</sup>

### (a) Taxable Capacity

An analysis of the equity of the distribution of a tax requires some measure of ability to pay (or ‘taxable capacity’).<sup>32</sup> In the past a competing distributional principle—the benefit principle—had some support. As its name suggests, the benefit principle maintains that a fair tax is one that is levied in accordance with the benefits received from the state.<sup>33</sup> Since the modern state provides a multitude of public goods, the benefits from which are

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requires equal taxation of people with equal ability and unequal taxation of unequal ability’). See also Martin S Feldstein, ‘On the Theory of Tax Reform’ (1976) 6 J Public Econ 77.

<sup>30</sup> Tiley (n 23) 10.

<sup>31</sup> See text at n 3.

<sup>32</sup> Meade Report (n 13) 14-15; Musgrave (n 29) 91; Carter Commission (n 13) Vol 3, 3.

<sup>33</sup> Meade Report (n 13) 12; Carter Commission (n 13) Vol 3, 3; Stiglitz (n 22) 403-4; Musgrave (n 29) 62 (‘In the benefit approach, the relation of taxpayer and government is seen, as John Stuart Mill puts it, in *quid pro quo* terms’). Both the ability to pay and benefit principles are reflected in Adam Smith’s first canon: ‘The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state’: Smith (n 16) 825.

difficult to value for any given taxpayer (eg police force, judicial system, and national defence), the benefit principle has fallen out of favour.<sup>34</sup>

Although taxing in accordance with ability to pay may be a desirable aim of taxation, it is a difficult concept to implement in practice. As the Meade Committee<sup>35</sup> and more recently Banks and Diamond in their paper for the Mirrlees Review<sup>36</sup> have said, no matter how described, taxable capacity always turns out to be very difficult to define and to be a matter on which opinions will differ rather widely. This is clear from a simple example: if Mrs A earns £30,000 and her co-worker Mr B earns £30,000, one may immediately conclude that A and B have the same taxable capacity and they should pay the same amount of tax. But even this simple situation is not so simple once we delve a little deeper into their respective situations: does one of them have young children, a physical disability, a stay-at-home spouse, do they live in rented or owned housing, have to pay for materials or supplies they use for work out of their own pocket, save a portion of their income or consume it all? Any or all of these factors might affect the judgment as to their ability to pay tax. Kay and King argue that the tax system should recognise

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<sup>34</sup> Meade Report (n 13) 12; James Banks and Peter Diamond, 'The Base for Direct Taxation' in James Mirrlees and others (eds), *Reforming the Tax System for the 21st Century: The Mirrlees Review* (The Institute for Fiscal Studies, London 2008) <<http://www.ifs.org.uk/mirrlees/mrPublications>> accessed 30 March 2009, 8 ('Discussion of the pattern of benefits received from government spending programs that affect the entire population did not achieve any consensus on its distributional significance and has disappeared from discussion of an ideal tax base. For example, it is hard to see how to allocate the benefit of military spending by income level in a way that is not too arbitrary to be useful.').

<sup>35</sup> Meade Report (n 13) 14 ('Is it similarity of opportunity or similarity of outcome which is relevant?' and 'Should differences in needs or tastes be considered in comparing taxable capacities?').

<sup>36</sup> Banks and Diamond (n 34) 9.

differences where they are involuntary, but not where they are a matter of choice.<sup>37</sup> But is having children ‘involuntary’ or a choice akin to buying a Rolls Royce?<sup>38</sup> Undoubtedly significant difficulties remain in deciding when people are in similar situations.

In fact Banks and Diamond go much further than merely acknowledging the practical difficulties in defining taxable capacity; they argue that taxable capacity should be rejected entirely as a normative basis in favour of an optimal tax theory utilitarian welfare approach:<sup>39</sup>

‘We reject the Meade Report view that taxes ‘should’ relate monotonically to taxable capacity. In addition to finding taxable capacity not well enough measurable and not sufficiently uniformly evaluated to be usable for this purpose, we also do not see an underlying normative basis for reaching the conclusion that taxes should be related to taxable capacity without full consideration of the equilibrium consequences of following such an approach. That is, we accept the view that the starting place for thinking about taxation should be the impact of taxes on the utilities of people in the economy.’

Kaplow takes a similar stance, arguing that ability to pay and other traditional tax equity criteria that deviate from the pure welfarism of the standard welfare economic framework are unhelpful and untenable.<sup>40</sup> These are extreme reactions to the difficulty in measuring taxable capacity, and in his commentary on Banks and Diamond’s paper Kay is highly critical of their conclusion:<sup>41</sup>

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<sup>37</sup> See eg JA Kay and MA King, *The British Tax System* (5<sup>th</sup> edn OUP, Oxford 1990) 41-42.

<sup>38</sup> Kay and King (n 37) 42.

<sup>39</sup> Banks and Diamond (n 34) 74-75.

<sup>40</sup> Kaplow (n 25) 391-406 and 414.

<sup>41</sup> John Kay, ‘The Base for Direct Taxation: Commentary’ prepared for James Mirrlees and others (eds), *Reforming the Tax System for the 21st Century: The Mirrlees Review* (The Institute for

‘It is certainly hard to disagree with Meade’s statement, echoed by [Banks and Diamond], that taxable capacity is difficult to define. But to say that it is hard to define does not necessarily imply that people are not justified in attaching significance to it, or that because it lacks exact meaning it lacks any meaning, or that it is impossible to secure a wide measure of agreement on what taxable capacity is.’

Kay draws an analogy to other concepts difficult to measure quantitatively: ‘...we are able to identify indicators of beauty, kindness and greatness and to achieve substantial, though not necessarily complete, consensus on rankings of beauty, kindness or greatness.’ Kay also questions whether ‘utility’ is any more easily defined than ‘taxable capacity’.<sup>42</sup>

‘If one is to maximise a social welfare function based on an aggregation of individual circumstances, it is necessary to envisage some agreement on what the individual arguments of that social welfare function (call them utilities) would be. I cannot imagine that it would be easier to secure agreement on the definition of utilities than on the definition of taxable capacities: indeed it is likely that the two definitions would be very similar. I believe it is difficult to argue that it is possible to define utilities but not to define taxable capacities.’

Kay further argues that although taxable capacity is unobservable, tax liabilities can and are based on instrumental variables that are believed to be correlated with taxable capacity, such as earnings, expenditure and relationship status.<sup>43</sup> These arguments are

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Fiscal Studies, London 2008) <<http://www.ifs.org.uk/mirrlees/mrPublications>> accessed 30 March 2009, 7-9. As John Kay was a member of the Meade Committee his continued support for the approach adopted by the Meade Report should not be surprising.

<sup>42</sup> Kay (n 41) 9.

<sup>43</sup> Kay (n 41) 9-13 (‘Taxable capacity is a complex concept, probably unobservable, and we must make do with composite instrumental variables’).

convincing, and ultimately even Banks and Diamond concede a role for equity in ‘providing limitations on the set of allowable tax policies.’<sup>44</sup>

## (b) Horizontal Equity

At first glance the principle that similarly-situated taxpayers should face a similar tax burden seems relatively uncontroversial: if Mr Smith and Mr Brown have the same ability to pay, should they not bear the same tax burden? Indeed, the merits of horizontal equity are generally assumed. For example, the Meade Committee stated ‘[t]he following point is clear: A good tax system should be horizontally equitable, i.e. should treat like with like’.<sup>45</sup> As discussed next, although the idea of taxing like alike is an attractive-sounding proposition, support for horizontal equity as an independent objective of taxation is not universal.

### (i) *The Normative Significance of Horizontal Equity*

Musgrave and Kaplow debated the normative significance of horizontal equity in the early 1990s, with Musgrave arguing in favour of horizontal equity as an independent

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<sup>44</sup> Banks and Diamond (n 34) 10, citing in support Anthony B Atkinson and Joseph E Stiglitz, *Lectures on Public Economics* (McGraw Hill, London 1980).

<sup>45</sup> Meade Report (n 13) 12. See also Carter Commission (n 13) Vol 1, 4, Henry Simons, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* (University of Chicago Press, Chicago 1938) 49 (‘...tax burdens should bear similarly upon persons whom we regard as in substantially similar situations...’) and Richard A Musgrave, ‘Horizontal Equity: A Further Note’ (1993) 1 *Florida Tax Rev* 354, 355 (‘I again begin with the observation that almost everyone agrees with the [horizontal equity] rule, which calls for equal treatment of people in equal positions. The general principle of [horizontal equity] is almost universally accepted’).

principle and Kaplow disagreeing.<sup>46</sup> A principle objection to horizontal equity is that it requires all those who are similarly situated in the pre-tax distribution should remain so in the post-tax distribution.<sup>47</sup> End-state theories of social justice (eg utilitarian or Rawlsian), however, assign values to particular distributions without regard to the pre-tax distribution; the situation of any particular individual before as compared to after taxes is irrelevant to an end-state theory.<sup>48</sup> Consequently, it is argued, horizontal equity imposes an unacceptable and undesirable constraint on such theories.<sup>49</sup>

The end-state theorists concerns can be illustrated in a simple example. Assume A has a pre-tax income of 100, B also has 100, and X has 25. Under the Rawlsian difference principle, should a different distribution be possible that is more beneficial to the least well off member of society, such a distribution should be adopted.<sup>50</sup> One such distribution might result in a post-tax situation where A is left with 90, B still has 100,

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<sup>46</sup> Louis Kaplow, 'Horizontal Equity: Measures in Search of a Principle' (1989) 42 National Tax J 139; Richard A Musgrave, 'Horizontal Equity, Once More' (1990) 43 National Tax J 113; Louis Kaplow, 'A Note on Horizontal Equity' (1992) 1 Florida Tax Rev 191; Musgrave (n 45); Paul R McDaniel and James R Repetti, 'Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange' (1993) 1 Florida Tax Rev 607; Kaplow (n 25) 396-401.

<sup>47</sup> David Elkins, 'Horizontal Equity as a Principle of Tax Theory' (2006) 24 Yale L & Policy Rev 43, 49. Elkin also considers whether economic efficiency, equality as a legal and philosophical concept, or theories justifying the market distribution (eg Nozickian) support the principle of horizontal equality but concludes they do not.

<sup>48</sup> Elkins (n 47) 52; Kaplow (n 25) 391-401.

<sup>49</sup> For example, Shaw, Slemrod and Whiting accept that their optimal tax theory approach to tax avoidance may result in horizontal inequity, but dismiss this concern: Jonathan Shaw, Joel Slemrod and John Whiting, 'Administration and Compliance' in James Mirrlees and others (eds), *Reforming the Tax System for the 21st Century: The Mirrlees Review* (The Institute for Fiscal Studies, London 2008) <<http://www.ifs.org.uk/mirrlees/mrPublications>> accessed 30 March 2009, 13 ('Indeed, not only does our optimal policy fail to eliminate horizontal inequity caused by evasion (doing so would require 'excessive' antiavoidance spending), it commonly involves creating additional horizontal inequity through the use of random audits and by making tax liability depend upon...immutable characteristics of individuals that are correlated with well-being'). See also Kaplow (n 25) 396-401.

<sup>50</sup> John Rawls, *A Theory of Justice* (OUP, Oxford 1971) 76-80.

and X has 45. This distribution violates horizontal equity in the treatment of A and B, but as X is better off than before it satisfies the Rawlsian difference principle. Horizontal equity is similarly problematic for optimal tax theory supporters. Kaplow offers the example of a society of two individuals, identical in all respects ex ante, and a reform that raises one individual's utility and lowers the other's utility by a smaller amount, with each individual having an equal chance of occupying each position.<sup>51</sup> Ex ante expected utility rises so both individuals would favour the reform, but if any weight is put on the violation of horizontal equity the reform will be opposed.<sup>52</sup>

In summary, for end-state theorists like Rawls and Kaplow, horizontal equity or inequity determined by comparing the pre-tax positions of A, B and X to their post-tax positions imposes unacceptable restrictions on desirable reforms.<sup>53</sup> Furthermore, Kaplow questions why it is necessary to accord direct normative significance to the status quo distribution of income (itself the product of countless changes throughout history), independent of the welfare consequences in the post-reform state.<sup>54</sup> Murphy and Nagel also reject the normative significance of the status quo: since they adopt the position that no one has an entitlement to his or her pre-tax income, a theory based on drawing comparisons to pre- and post-tax situations is irrelevant for Murphy and Nagel.<sup>55</sup>

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<sup>51</sup> Kaplow (n 25) 398.

<sup>52</sup> Kaplow (n 25) 398.

<sup>53</sup> Elkins (n 47) 55.

<sup>54</sup> Kaplow (n 25) 398 and Kaplow (1989) (n 46) 146.

<sup>55</sup> Liam Murphy and Thomas Nagel, *The Myth of Ownership: Taxes and Justice* (OUP, Oxford 2002) 32-33.

Musgrave, on the other hand, argues that horizontal equity reflects ‘a basic premise of social mores—as stated in the biblical golden rule or the Kantian imperative—with which all just people will (must) agree’.<sup>56</sup> End-state theories that consider horizontal equity concerns to be irrelevant are ‘insufficient’ formulations in his view.<sup>57</sup> Musgrave argues that these end-state theories must adopt a more complex ‘meta set’ that incorporates the addition of a horizontal equity component.<sup>58</sup> Kay is similarly concerned with the implications of end-state theories, particularly the optimal tax theory approach.<sup>59</sup> It is noteworthy that Banks and Diamond ultimately adopt this meta set approach in their Mirrlees paper (despite their concerns over taxable capacity as a normative basis for tax policy generally) and allow equity to act as a constraint on the allowable set of tax policies.<sup>60</sup>

## *(ii) Horizontal Equity and the Income Splitting Debate*

Horizontal equity considerations are fundamental to the income-splitting debate because it is relatively easy (in theory at least) to draw comparisons between two similarly-situated families, one who enters into an arrangement to split income from the family

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<sup>56</sup> Musgrave (n 45) 355.

<sup>57</sup> Musgrave (n 45) 355.

<sup>58</sup> Musgrave (n 45) 356. Musgrave’s use of the term ‘meta set’ is derived from the work of Stiglitz: see Joseph E Stiglitz ‘Utilitarianism and Horizontal Equity: The Case for Random Taxation’ (1982) *J Public Econ* 18, 28. Musgrave also finds support in the ‘tradeoff’ approach adopted by Feldstein who concludes it becomes necessary ‘to balance the desire for horizontal equity against the utilitarian principle of optimal taxation’: see Feldstein (n 29) 97.

<sup>59</sup> Kay (n 41) 11 (‘The person unfamiliar with the implications of models like those of optimal tax theory might be surprised at the notion that there is potential conflict between the objective of welfare maximisation and the requirement that the tax burden should be an increasing function of the taxable capacity of individuals’).

<sup>60</sup> Text at n 44.

business amongst family members and another family where all of the income is taxed in the hands of one family member (ie the family member most active in the business). Horizontal equity, it could be argued, requires similar tax treatment of these two families.

Comparisons for horizontal equity purposes are also drawn between employees (who have limited scope for splitting their employment earnings) and business persons (who have more opportunities to income split). Some commentators argue that persons with similar outcomes should face similar tax burdens and ‘it should be irrelevant whether those outcomes arise from conducting business or offering services as an employee’.<sup>61</sup> If employees and business persons are indeed in similar situations, horizontal equity supports similar tax treatment, including similar rules governing income splitting. Other commentators, on the other hand, argue that business persons should not be compared with employees because the nature, risks and rewards of running a business are not the same as being an employee.<sup>62</sup> If this is the case, horizontal equity is not a relevant consideration. Similarly, can useful comparisons be drawn between unincorporated family businesses (such as a husband and wife partnership) and incorporated family businesses (where the shareholders are husband and wife) for horizontal equity purposes? These questions are discussed in detail in Chapter 4.<sup>63</sup>

### (c) Vertical Equity

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<sup>61</sup> Malcolm Gammie, ‘Reflections on Jones v Garnett’ [2007] BTR 687, 692.

<sup>62</sup> See eg Anne Redston, ‘Income Splitting: The Nelsonian Option’ [2007] BTR 680, 681.

<sup>63</sup> Chapter 4, text at n 478.

Whilst horizontal equity is concerned with treating like alike, vertical equity is about redistribution from those who are better off to those who are worse off.<sup>64</sup> The principle of vertical equity seems to follow on from the principle of horizontal equity—if those with similar taxable capacity should pay similar tax, then surely those with higher (or lower) capacity should pay higher (or lower) amounts of tax?<sup>65</sup> The main difficulty with the application of the vertical equity principle lies in determining how *much* more or less tax one person should pay relevant to another, differently-situated person.<sup>66</sup> In other words, how redistributive should the tax system be, which particular distributive justice model should be adopted and on what basis?

These are difficult questions to answer and conceptions of distributive justice in tax differ widely. Optimal tax theory supporters such as Kaplow and also Banks and Diamond examine the economic consequences of various tax structures in terms of their effect on the aggregate levels of lifetime wellbeing or ‘utility’ for all the people in the economy determined in accordance with a social welfare function that aggregates individual utilities across society in some way.<sup>67</sup> As Musgrave notes, however, optimal

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<sup>64</sup> Meade Report (n 13) 14; Carter Commission (n 13) Vol 1, 4-5.

<sup>65</sup> Musgrave (n 45) 354 and Musgrave (n 29) 160.

<sup>66</sup> Musgrave (n 45) 355.

<sup>67</sup> See Banks and Diamond (n 34) 9. Kaplow discusses a variety of possible social welfare functions (‘SWF’) and their relevance to optimal tax policy. He acknowledges that ‘[t]he relevance of choice of SWF to optimal tax policy varies greatly: often with no effect, sometimes a difference in magnitude, and occasionally a difference in direction’: see Kaplow (n 25) 41-50.

tax theory as a utilitarian-based approach is but one form of one approach amongst many to the justice in tax question.<sup>68</sup>

‘X, who sees distributive justice in Lockean terms of entitlement to earnings, will view justice in taxation in benefit terms: people who value public services equally should pay a similar tax price. Y and Z, who take a utilitarian approach, will view as just that distribution of the tax burden which minimizes the aggregate welfare loss, but the shape of their subjective welfare functions will differ. Others may choose yet different criteria of fairness, such as a burden distribution which imposes a proportional loss.’

Consequently, Musgrave’s approach to the lack of consensus on vertical equity is to give horizontal equity primacy over vertical equity: so long as ‘the primary principle’ of treating like alike is complied with just individuals are then free to disagree on the desirable pattern of vertical equity.<sup>69</sup>

Whatever one’s preferred conception of tax justice, a measure of the extent of vertical equity in a tax system that is especially relevant to the issue of family income splitting is the progressivity of the tax concerned, ie how much a taxpayer’s income tax burden increases as his or her income increases, not just in absolute dollars but relative to his or her income.<sup>70</sup> The progressivity of the tax system is a key factor in the income-splitting context because the more progressive the system, the more combined tax can be saved by a high-income family member shifting income to a lower-income family

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<sup>68</sup> Musgrave (n 45) 354. For a review of libertarian approaches to private property and their implications for tax policy see David Duff, ‘Private Property and Taxation in a Libertarian World: A Critical Review’ (2005) 18 Can J of L and Juris 23.

<sup>69</sup> Musgrave (n 45) 355-56. See also Musgrave (n 29) 160 (‘Indeed, it has been suggested that the rule of horizontal equity is valid, even though little can be said about the matter of *vertical equity* or about how the taxation of people in different positions should differ’).

<sup>70</sup> The base does not need to be income. A progressive wealth tax would increase as one’s wealth increased.

member. For example, following tax rate increases announced in the 2009 Budget that will increase the progressivity of the UK income tax, UK families will have an even greater incentive than before to seek tax savings from income-splitting arrangements.<sup>71</sup> From April 2010, the top marginal personal income tax rate is set to rise from 40% to 50%. In addition, those taxpayers with income between £100,000 and approximately £113,000 will face a 60% marginal tax rate on that income due to the withdrawal of personal allowances for those with income over £100,000.

Progressivity in the tax system is supported for a number of reasons, but primarily on the basis of ability to pay and the declining marginal utility of money (ie £1 is worth more to someone who is very poor than someone who is very rich).<sup>72</sup> Whilst the poor need every pound to be able to pay for the essentials of life such as food and shelter, rich people cannot only afford the essentials but have a large amount of money left over, and thus, it is argued, are able to pay a greater percentage of it to the State.<sup>73</sup> In addition, Bankman and Griffin argue that the optimal tax under most normative theories and

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<sup>71</sup> HM Treasury, '2009 Budget' (n 7) [5.88]. Additional Budget 2009 measures that will have the effect of increasing the progressivity of the UK income tax include a rise in the tax rate applicable to trusts to 50% and the top tax rate on dividends (before taking into account the accompanying tax credit) to 42.5%. Pension relief for high-income earners will also be restricted from April 2011.

<sup>72</sup> Carter Commission (n 13) Vol 1, 19-22; Stiglitz (n 22) 77; Musgrave (n 29) 102-5. For a strong defence of progressive taxation on distributive justice and optimal tax grounds see Joseph Bankman and Thomas Griffin, 'Social Welfare and the Rate Structure: A New Look At Progressive Taxation' (1987) 75 Calif L Rev 1905. For a more general discussion on the arguments for and against progressivity see Tiley (n 23) 16-18.

<sup>73</sup> Carter Commission (n 13) Vol 1, 19-20 ('Because we believe that non-discretionary expenses absorb a much larger proportion of the annual additions to the economic power of those with low income than of the wealthy, in order to attain the proportionate taxation of discretionary economic power, we recommend that a base that measures total economic power be taxed at progressive rates').

empirical assumptions is progressive.<sup>74</sup> Progressivity, however, is not universally accepted.<sup>75</sup> Opponents of progressivity argue that a proportionate or flat tax is more desirable,<sup>76</sup> primarily on administrative simplicity<sup>77</sup> and work incentives or productivity grounds.<sup>78</sup> Most flat tax proposals include a large, untaxed personal exemption and thus are more accurately described as a two-rate (zero and the flat rate) progressive tax.<sup>79</sup> Thus, for purposes of this thesis, the income tax system is assumed to be progressive.

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<sup>74</sup> Bankman and Griffin (n 72) 1907.

<sup>75</sup> Testimony of J S Mill in Report of the Select Committee on Income and Property Tax 'Minutes of Evidence Taken before the Committee' Vol VII (1861) [Q3540] ('The rule of equality and of fair proportion seems to me to be that people should be taxed in an equal ratio on their superfluities, necessities being untaxed, and surplus paying in all cases an equal percentage. This satisfies entirely the small amount of justice that there is in the theory of a graduated income tax, which appears to me to be otherwise an entirely unjust mode of taxation, and, in fact, a graduated robbery'); Walter J Blum and Harry Kalven Jr, 'The Uneasy Case for Progressive Taxation' (1952) 19 U Chicago L R 471.

<sup>76</sup> See eg Richard Teather, *A Flat Tax for the UK – a Practical Reality* (Adam Smith Institute, London 2005) <<http://www.adamsmith.org/publications/economy/flat-tax-for-the-uk-2007112088/>> accessed 30 March 2009, 3 and Andrei Greco, *Flat Tax – The British Case* (Adam Smith Institute, London 2004) <<http://www.adamsmith.org/publications/economy/flat-tax:-the-british-case-2007111645/>> accessed 30 March 2009, 4. In the United States, the flat tax is associated primarily with Robert Hall and Alvin Rabushka, who proposed a combination of a cash-flow tax on business income and a tax on labour income both subject to the same flat rate (with a personal allowance for labour income): Robert E Hall and Alvin Rabushka, *The Flat Tax* (Hoover Institution Press, Stanford 1985).

<sup>77</sup> Blum and Kalven (n 75) 430-35 ('The first such consideration is the price paid for progression in terms of complicating the structure of the income tax, expanding the opportunity for taxpayer ingenuity directed to lawfully avoiding taxes, creating very difficult questions of equity among taxpayers, and obscuring the implications of any given provision in the tax law'); Hall and Rabushka (n 76) 52-54; Teather (n 76) 3; Greco (n 76) 19-20. Administrative simplicity is discussed below; see text at n 115.

<sup>78</sup> Blum and Kalven (n 75) 437-44 ('A third line of objection to progression, and undoubtedly the one which has received the most attention, is that it lessens the economic productivity of the society'); Hall and Rabushka (n 76) 45-47; Teather (n 76) 3; Greco (n 76) 19-20. Work incentives are discussed below in the context of neutrality; see text at n 86.

<sup>79</sup> Michael Keen, Yitae Kim and Ricardo Varsano, *The 'Flat Tax(es)': Principles and Evidence*, IMF Working paper WP/06/218 (International Monetary Fund, Washington DC 2006) <<http://www.imf.org/external/pubs/ft/wp/2006/wp06218.pdf>> accessed 30 March 2009, 4 (surveying the flat taxes imposed in eight east-European countries). In 2005 Teather (n 76) argued a flat rate of tax of 22% combined with a tax-free personal allowance of £12,000 was a practical possibility for the UK.

Vertical equity arguments often arise in the context of family income splitting. For example, some claim that it is unfair that families with investment income can reduce their total income tax burden by entering into income-splitting arrangements whilst families with only earned income cannot.<sup>80</sup> One interpretation of this argument is that these two types of families are in similar situations and should face similar tax burdens under the principle of horizontal equity. But is this really the case? Consider these two fact patterns:

Mr and Mrs Employment: Mr E earns a modest living working full-time as an employee. Mrs E stays at home looking after the couple's children.

Mr and Mrs Investment: Mr I has a substantial income from a share portfolio, bank savings, and a rental property. Mrs I stays at home looking after the couple's children.

On these facts, it is difficult to argue that the two couples are similarly situated. One couple appears to have a much higher ability to pay than the other, not to mention that the sources of their respective incomes are different (and perhaps Mr E's earnings could be described as more hardily won), which may be quite relevant. As such, it appears to be raising vertical equity rather than horizontal equity concerns, and arriving at anything approaching a consensus on how these two groups should be taxed relative to each other becomes much more difficult.

To take a second example, it is sometimes argued that a husband and wife who own a personal services company, with no other employees, should not be treated less

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<sup>80</sup> Redston (n 62) 681; Judith Freedman and Rhona Schuz, 'Settlements – A Suitable Case for Treatment: Clauses 109-110 Finance Bill 1989' [1989] BTR 204, 205.

favourably than a husband and wife owning a very large business with factories, hundreds of shops and employing thousands of employees.<sup>81</sup> Again, are these couples similarly-situated such that horizontal equity concerns are relevant? In both cases the couples are running a business. However, in the case of the very large business the profits earned represents to a much greater extent than the personal services business a return on the significant amounts of capital invested in the business rather than principally a return on the labour of the owners. If these returns should be taxed the same then the issue is one of the proper application of the principle of horizontal equity. Alternatively, if the returns are not equivalent, and one can justifiably impose different levels of tax on the small business owners from the tax imposed on the large-business owners, then this is a question of vertical not horizontal equity and requires a solution along those lines.<sup>82</sup>

## 2. NEUTRALITY

Another guiding principle of taxation is neutrality—a well-designed tax system should not distort decisions (except where intended to do so).<sup>83</sup> Distortions can be introduced, for example, by levying high marginal rates of tax or imposing different levels of tax on essentially similar activities. Treating like alike thus makes good tax policy not just

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<sup>81</sup> Statement by Malcolm Gammie at London School of Economics tax policy seminar discussion on *Jones v Garnett* (London 3 December 2007).

<sup>82</sup> Whether income from capital should be taxed the same, less heavily or more heavily than income from labour is discussed in Chapter 4: see text at n 438.

<sup>83</sup> Meade Report (n 13) 7-11; Carter Commission (n 13) Vol 3, 8; Boadway and Wildasin (n 20) 226-27; Sandford (n 21) 113-14; Stiglitz (n 22) 328-331; Rachel Griffith, James Hines and Peter Birch Sørensen, 'International Capital Taxation' in James Mirrlees and others (eds), *Reforming the Tax System for the 21st Century: The Mirrlees Review* (The Institute for Fiscal Studies, London 2008) <<http://www.ifs.org.uk/mirrlees/mrPublications>> accessed 30 March 2009, 17.

because it is horizontally equitable, but also because it is neutral.<sup>84</sup> Fiscal neutrality does not mean that the tax system should or has no effect on behaviour; policy makers may deliberately choose to use the tax system to influence behaviours such as by imposing taxes on cigarettes to encourage people to stop smoking, or providing favourable tax treatment for married couples but not for unmarried cohabitants as a means of supporting the institution of marriage.<sup>85</sup>

Economists typically analyse the incentive effects of tax systems in terms of *income effects* and *substitution effects*.<sup>86</sup> Income effects depend on the overall level of tax; if the average rate of tax increases, the taxpayer will need to increase his or her pre-tax income (eg by working overtime) to avoid suffering a fall in his or her current standard of living. Substitution effects, on the other hand, depend on marginal tax rates and are more likely to lead to inefficient behaviour. The Meade Report uses the example of Mr Smith to illustrate substitution effects: Mr. Smith could add £100 a year to the value of his employer's output by working an extra hour of week, and he is happy to do so. Since his marginal tax rate is 40%, he is left with only £60 after tax. If Mr Smith would prefer the extra hour of leisure rather than the £60, the tax system has caused an economic inefficiency: absent taxes Mr Smith would have been better off by £100 and his

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<sup>84</sup> Although horizontal equity and economic efficiency may overlap (as in this example), the concerns of each are fundamentally different: see Elkin (n 47) 49.

<sup>85</sup> 'Marriage neutrality' is discussed in detail in Chapter 3; see text at n 278.

<sup>86</sup> See eg Meade Report (n 13) 8.

firm would have been no worse off, having generated an extra £100 of output to offset the extra £100 paid to Mr Smith.<sup>87</sup>

The substitution effect is particularly important in the context of family taxation. In a tax system that uses a joint spousal tax unit, if the husband's marginal tax rate is high this will create a disincentive for his stay-at-home wife with young children to return to the paid work force because her first pound of income will be taxed at his high marginal tax rate.<sup>88</sup> The higher the marginal tax rates, the stronger the incentive she will have to substitute untaxed domestic work for taxed earnings outside the home. The presence of the tax incentives may lead her to decide to stay at home when she otherwise (absent a high marginal tax rate) would have opted for paid employment. In addition, the greater the differences in the marginal tax rates of family members, the greater the incentive for family members to shift income (or income-producing property) around the family purely to obtain a lower combined tax burden, in the process incurring otherwise unnecessary and inefficient transaction costs.

Imposing different tax treatment on different types of income also may give rise to economic distortions. For example, in the UK, labour income is taxed more heavily than unearned/capital income (eg interest, dividends and capital gains). Income from employment is taxed at marginal income tax rates of up to 40% (for 2008-09). In addition, employment earnings are subject to employee national insurance contributions (NICs) of up to 11% (capped at 1% for incomes over £40,400) as well as employer NICs

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<sup>87</sup> Meade Report (n 13) 8.

<sup>88</sup> This issue is discussed in Chapter 3 under the heading 'Work Incentives'; see text at n 371.

of up to 12.8% (for 2008-09).<sup>89</sup> This results in a top marginal tax plus NIC rate for employees of 41%.<sup>90</sup> If the NIC rate for employers is also taken into account the top rate on labour income approaches 54%. Capital gains, on the other hand, are subject to a flat, comparatively low, tax rate of 18%, with no allowance for inflation but a large, separate annual exemption (£9,600 in 2008-09).<sup>91</sup> The substantial difference in tax in the UK on labour as compared to capital income provides a strong incentive for taxpayers to convert labour income into capital income where possible.<sup>92</sup> Such differential taxation also appears to violate both horizontal equity (£1 of labour income is taxed much more heavily than £1 of capital gain) and vertical equity (if it is primarily rich people who have

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<sup>89</sup> HM Revenue & Customs, 'Rates and Allowances - National Insurance Contributions' <<http://www.hmrc.gov.uk/rates/nic.htm>> accessed 16 June 2009.

<sup>90</sup> James Browne, 'Income tax and National Insurance' in R Chote and others (eds), *The IFS Green Budget, January 2009* (The Institute for Fiscal Studies, London 2009) [11.2] and Stuart Adam, James Browne and Christopher Heady, 'Taxation in the UK' in James Mirrlees and others (eds), *Reforming the Tax System for the 21st Century: The Mirrlees Review* (The Institute for Fiscal Studies, London 2008) <<http://www.ifs.org.uk/mirrlees/mrPublications>> accessed 30 March 2009, 8. Although the payment of NICs entitles individuals to certain social security benefits, in practice, the link between contributions paid and benefits received bear little relation to each other for any individual contributor. As a result, NICs generally are considered by economists to be simply a tax. For a detailed discussion on why NICs are considered merely a tax as well as the benefits from integrating income tax and NICs see Stuart Adam and Glen Loutzenhiser, *Integrating Income Tax and National Insurance: An Interim Report*, IFS Working Paper WP21/07 (The Institute for Fiscal Studies, London 2007) 14-15.

<sup>91</sup> TCGA 1992 ss 3(2) and 4.

<sup>92</sup> This form of what economists call 'tax arbitrage' is discussed in detail in Chapter 4; see text at n 481. As mentioned in the first footnote in the Introduction to this thesis, some economists refer to the conversion of labour income into capital income as 'income shifting' or 'income splitting': see eg Banks and Diamond (n 34) 27, Griffith, Hines and Sørensen (n 83) 75 and Peter Birch Sørensen, 'Neutral Taxation of Shareholder Income' (2005) 12 *International Tax and Public Finance* 777. This thesis, however, uses the terms 'income shifting' or 'income splitting' to describe attempts by one taxpayer to divert income to another taxpayer, eg a spouse or other family member, to reduce the tax otherwise paid on that income. See also Gammie (n 61) 691.

lightly-taxed capital gains, for example, not poor working people). These issues are considered in more detail in Chapter 4.<sup>93</sup>

In addition to horizontal equity concerns, taxing different legal forms of carrying on economic activities differently (eg employment, self-employment and incorporated business) may give rise to distortions.<sup>94</sup> A taxpayer who adopts the corporate form for his or her activities may be able to save tax by converting what would otherwise be heavily-taxed labour income into, at least partly, lower-taxed capital income.<sup>95</sup> In addition, self-employed persons may be subject to more generous rules on claiming expenses than an employee carrying on similar activities.<sup>96</sup> Moreover, if the tax system provides more opportunities for family income splitting through a company than an unincorporated business, there will be an incentive to adopt a corporate form over an unincorporated form. These considerations are also addressed in more detail in Chapter 4.<sup>97</sup> Finally, it should be noted that if the tax burden on one business is low because the owners of that

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<sup>93</sup> See text at n 438.

<sup>94</sup> Meade Report (n 13) 9; Claire Crawford and Judith Freedman, 'Small Business Taxation: A Special Study of the Structural Issues Surrounding the Taxation of Business Profits of Owner Managed Firms' in James Mirrlees and others (eds), *Reforming the Tax System for the 21st Century: The Mirrlees Review* (The Institute for Fiscal Studies, London 2008) <<http://www.ifs.org.uk/mirrlees/mrPublications>> accessed 30 March 2009, [I.1]; Alan J Auerbach, Michael P Devereux, and Helen Simpson, 'Taxing Corporate Income' in James Mirrlees and others (eds), *Reforming the Tax System for the 21st Century: The Mirrlees Review* (The Institute for Fiscal Studies, London 2008) <<http://www.ifs.org.uk/mirrlees/mrPublications>> accessed 30 March 2009, 34-35. The question as to whether it is appropriate to conclude that employees, the self employed and companies are carrying on analogous economic activities to make any meaningful comparison of their respective tax treatment is discussed in more detail in Chapter 4; see text at n 478.

<sup>95</sup> Gammie (n 61) 691-92; Banks and Diamond (n 34) 27; Griffith, Hines and Sørensen (n 83) 75.

<sup>96</sup> Judith Freedman, *Employed or Self-Employed? Tax Classification of Workers and the Changing Labour Market* (The Institute for Fiscal Studies, London 2001) 130-141; Crawford and Freedman (n 94) [II.2.3].

<sup>97</sup> See text at n 481 and also n 582.

business are able to split income amongst family members, the business will have a competitive advantage over other, perhaps more efficient, businesses that are unable to lower their tax burden through income splitting. In effect, the tax system is subsidising the less efficient business.

In summary, aligning the tax treatment of different sources of income and different forms of similar activities enhances the neutrality of the tax system by removing incentives for taxpayers to earn one form of income over another (or convert one form of income into another) and also the incentive to carry out taxable activities in a particular legal form. Removing these tax incentives not only means that the choice of business form can be made for commercial rather than tax reasons (eg choosing to incorporate for limited liability protection or, in the case of less complicated businesses, remaining in a cheaper and easier to administer unincorporated form), but it also means the tax system is not favouring particular businesses over others. Pursuing neutrality in these situations has the added benefit of advancing horizontal equity.

### **3. CERTAINTY**

Smith's second canon of taxation states that the tax which each individual is bound to pay ought to be certain, and not arbitrary. For Smith, certainty was of critical importance: 'The certainty of what each individual ought to pay is, in taxation, a matter of so great importance, that a very considerable degree of inequality...is not near so great an evil as a

very small degree of uncertainty'.<sup>98</sup> The Meade Committee also took the view that it should be clear to taxpayers what is and what is not taxable, and the amount of tax payable on each taxable object should be certain.<sup>99</sup> It is difficult to argue with the proposition that tax rules, indeed legal rules generally,<sup>100</sup> need to be clear and easy to understand. Taxpayers should be able to know their tax liability, where and when to pay it, and tax should be levied at a time and in the manner that is most likely to be convenient for taxpayers to pay. Certainty, it is argued, is particularly important for small business persons who must self-assess their income tax liability and often do not have access to, or the resources to pay for, professional advice.<sup>101</sup>

What is meant by 'certainty' and must law generally, and tax law in particular, always be completely certain to be legitimate and enforceable? Could 'mostly certain' be acceptable? How high must the certainty threshold reach? Freedman has considered the meaning of certainty specifically in the tax law context, and its relationship with the rule of law, in a paper on tax avoidance.<sup>102</sup> She refers to the work of legal theorists including Endicott to challenge the strength of the oft-raised argument that a particular tax proposal is 'too uncertain'.<sup>103</sup> Freedman questions whether the failure to draw bright lines results

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<sup>98</sup> Smith (n 16) 825-26 ('The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person').

<sup>99</sup> Meade Report (n 13) 18-19. See also Sandford (n 21) 116 ('...the individual's tax liability should not be arbitrary and should be calculable in advance').

<sup>100</sup> Lon Fuller, *The Morality of Law* (2nd edn Yale University Press, New Haven 1969) 63.

<sup>101</sup> Redston (n 62) 686; Anne Redston, 'Arctic Shift' (10 January 2008) 161 *Taxation* 17; Francesca Lagerberg, 'No Sense of Direction' (28 February 2008) 161 *Taxation* 187; Andrew Hubbard, 'The Curious Incident ...' (27 March 2008) 161 *Taxation* 281.

<sup>102</sup> Judith Freedman, 'Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle' [2004] *BTR* 332, 345.

<sup>103</sup> Freedman (n 102) 345.

in a real problem and concludes that it may be not only inevitable but perhaps even helpful in the tax avoidance context to steer away from any attempt to define the line categorically.<sup>104</sup> Since past proposals (and no doubt future ones as well) to change the tax treatment of income-splitting arrangements involving family businesses have been criticised by taxpayers, practitioners and professional organisations on uncertainty grounds,<sup>105</sup> the concept of certainty in tax law is especially relevant to this thesis and bears closer scrutiny.

Legal philosophers have considered the role of certainty in law. In *The Morality of Law*, Fuller set out his famous eight routes of failure for any legal system, one of which was unclear or obscure legislation that is impossible to understand.<sup>106</sup> The need for clear legislation does not mean, however, that rules need to be detailed and cover every conceivable fact pattern:<sup>107</sup>

To put a high value on legislative clarity is not to condemn out of hand rules that make legal consequences depend on standards such as “good faith” and “due care”. Sometimes the best way to achieve clarity is to take advantage of, and to incorporate into the law, common sense standards of judgment that have grown up in the ordinary life outside legislative halls. After all, this is something we inevitably do in using ordinary language itself as a vehicle for conveying legislative intent. Nor can we ever, as Aristotle long ago observed, be more exact than the nature of the subject matter with which we are dealing admits. A specious clarity can be more damaging than an honest open-ended vagueness.

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<sup>104</sup> Freedman (n 102) 345.

<sup>105</sup> Chapter 6, text at n 914.

<sup>106</sup> Fuller (n 100) 63-65.

<sup>107</sup> Fuller (n 100) 64.

Furthermore, as Endicott explains, whilst legal philosophers have debated the virtue in the rule of law, there is a consensus about the requirements of the ideal: ‘laws must be open, clear, coherent, prospective, and stable; legislation and executive action should be governed by laws with those characteristics; and there must be courts that impose the rule of law.’<sup>108</sup> Endicott argues that the organising principle of these requirements is, as Raz puts it, that ‘the law must be capable of guiding the behaviour of its subjects’.<sup>109</sup> Law that fails altogether to meet the requirements is not law at all, and a legal system that lacks them to some degree is defective or deficient in a legal sense. In Finnis’s phrase, a legal system must meet the requirements if it is to be ‘legally in good shape’.<sup>110</sup>

In Endicott’s view, these requirements of the rule of law seem to offer an answer to the question of what counts as achieving the ideal: if the ideal is to be completely met, the requirements must be completely met, and to pursue the rule of law is to maximise conformity to the requirements.<sup>111</sup> This does not mean, however, that vagueness must be eliminated. For Raz, conformity to the rule of law is a matter of degree and ‘some vagueness is inescapable’.<sup>112</sup> Similarly, Endicott concludes that legal systems necessarily contain vague laws and vagueness is not a deficit.<sup>113</sup> Freedman contends in the tax avoidance context that in some cases the focus needs to be shifted away from trying to create clear lines (which may be impossible in any event) towards an examination of how

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<sup>108</sup> Timothy Endicott, ‘The Impossibility of the Rule of Law’ (1999) 19 OJLS 1.

<sup>109</sup> Joseph Raz, *The Authority of Law* (Clarendon Press, Oxford 1979) 214.

<sup>110</sup> John Finnis, *Natural Law and Natural Rights* (OUP, Oxford 1980) 270-71.

<sup>111</sup> Endicott (n 108) 1-3.

<sup>112</sup> Raz (n 109) 222.

<sup>113</sup> Endicott (n 108) 4-5; Raz (n 109) 222.

the law can enable decisions to be made in individual cases fairly and within a legitimate and non-arbitrary framework.<sup>114</sup>

In summary, whilst certainty is an important objective, some vagueness in law is inescapable and tax law in particular will never be completely certain. This is a reflection of the nature of law generally and tax law specifically. An appreciation of this nature of certainty is important in the context of income splitting from family businesses, and, in particular, legislative responses to this issue. So long as the rules adopted are not arbitrary and outcomes can be adequately predicted such that advisors can provide useful advice to guide clients' behaviour, blanket criticism that a given tax rule is 'too uncertain' should be met with a healthy degree of scepticism. On the other hand, the importance of certainty for small business persons, who must self-assess their income tax liability and have limited resources to pay for professional advice, must not be overlooked.

#### **4. ADMINISTRATION AND COMPLIANCE COSTS**

According to Smith's fourth canon: 'Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the State.'<sup>115</sup> The Meade Committee also considered it to be important that the tax system be coherent, simple and straightforward, with ease of

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<sup>114</sup> Freedman (n 102) 345-46.

<sup>115</sup> Smith (n 16) 826.

administration comprising one aspect of simplicity.<sup>116</sup> The more complex the rules, the more it will normally cost government to administer and taxpayers to comply with.<sup>117</sup>

Administration and compliance costs are important considerations from a tax policy perspective because they represent pure social loss from the total goods and services available to the community.<sup>118</sup> Governments need to hire tax inspectors and others to administer the system. Taxpayers and third parties charged with assisting in the administration of the system (eg employers and banks required to withhold and remit taxes) spend time and effort fulfilling their respective tax compliance obligations, perhaps employing outside advisors to help them do so. These costs can vary dramatically depending on the nature of the tax involved and are generally lower for simpler taxes—those with fewer rates, borderlines and reliefs.<sup>119</sup> In the UK, for example, stamp duty costs HMRC very little to administer – about 0.13 pence per pound collected in 2006-07. Income tax, on the other hand, is one of the most expensive, costing HMRC 1.25 pence per pound collected.<sup>120</sup> The costs to taxpayers of compliance with a given tax may well be higher than the costs to the government.<sup>121</sup>

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<sup>116</sup> Meade Report (n 13) 18-21. See also Carter Commission (n 13) Vol 1, 3-4; Boadway and Wildasin (n 20) 227; Sandford (n 21) 114-17; Stiglitz (n 22) 331-32.

<sup>117</sup> Meade Report (n 13) 20.

<sup>118</sup> Shaw, Slemrod and Whiting (n 49) 6.

<sup>119</sup> Shaw, Slemrod and Whiting (n 49) 20. The authors also note that administration and compliance costs across multiple taxes can be reduced by adopting common bases, definitions and procedures. This and other benefits from the alignment of national insurance and income tax are considered in Chapter 6; see text at n 975.

<sup>120</sup> HM Revenue & Customs, *Autumn Performance Report 2007*, Table 1 <<http://www.hmrc.gov.uk/about/autumn-report-2007.pdf>> accessed 17 July 2008.

<sup>121</sup> Meade Report (n 13) 20.

Ease of administration often conflicts with other tax policy considerations. As Shaw, Slemrod and Whiting state in their paper for the Mirrlees Review, ‘a reform that looks attractive when considering only distortion costs may be very unattractive when administrative and compliance costs are taken into consideration.’<sup>122</sup> Highfield goes further, arguing that the political dimension to tax policy sometimes results in decisions that give little or no regard to, or even fly in the face of, administrative or compliance cost considerations.<sup>123</sup> For Highfield, this political factor, coupled with the use of tax systems for a plethora of objectives unrelated to their primary revenue-raising role in part explain why tax systems in advanced economies such as the UK have become so complex and costly to administer.<sup>124</sup>

One area in which the goals of equity and ease of administration conflict is the question of whether the income tax base should include imputed income from domestic services—equity may require inclusion, but taxing such imputed income is generally viewed as unworkable in practice.<sup>125</sup> Fairness might also suggest unmarried cohabitants in a stable long-term relationship should be taxed no higher and no lower than a similarly-situated married couple.<sup>126</sup> But how do you define ‘a stable long-term relationship’? Must there be a sexual component to the couple’s relationship to qualify?

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<sup>122</sup> Shaw, Slemrod and Whiting (n 49) 10.

<sup>123</sup> Richard Highfield, ‘Tax Implementation: Commentary’ prepared for James Mirrlees and others (eds), *Reforming the Tax System for the 21st Century: The Mirrlees Review* (The Institute for Fiscal Studies, London 2008) <<http://www.ifs.org.uk/mirrlees/mrPublications>> accessed 5 April 2009, 4.

<sup>124</sup> Highfield (n 123) 4.

<sup>125</sup> Tiley (n 23) 20-22.

<sup>126</sup> ‘Couples neutrality’ is discussed in detail in Chapter 3; see text at n 338.

The more the tax system must take into account individual circumstances the more complex it will be, the more information it will need, the more intrusive it will be into taxpayers' personal lives, and the more costly it will be to administer and police. Progressivity itself also adds to complexity through substitution effects and encouraging income splitting. Certainty can often come at the expense of complexity and cost, whilst in other cases a certain rule will be easy to understand and simple to administer.<sup>127</sup>

Another important aspect of ease of administration is the transitional issues and costs resulting from changes to the tax regime. According to Raz, one of the more important principles that can be derived from the basic idea of the rule of law is that laws should be relatively stable.<sup>128</sup> Stability is important because people need to know the law not only for short-term decisions but also for long-term planning: '[k]nowledge of at least the general outlines and sometimes even of details of tax law and company law are often important for business plans which will bear fruit only years later'.<sup>129</sup> Shaw, Slemrod and Whiting observe that a major component of compliance costs is the cost of understanding which obligations apply to a taxpayer and what needs to be done to comply with those obligations.<sup>130</sup> As a result, the authors similarly conclude that stability is 'a highly desirable feature of a tax system, since learning what to do is much more costly the first

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<sup>127</sup> Chris Evans, 'Studying the Studies: An Overview of Recent Research into Taxation Operating Costs' (2003) 1 eJournal of Tax Research 64 and Chris Evans, 'Taxation in the UK: Commentary' prepared for James Mirrlees and others (eds), *Reforming the Tax System for the 21st Century: The Mirrlees Review* (The Institute for Fiscal Studies, London 2008) <<http://www.ifs.org.uk/mirrlees/mrPublications>> accessed 5 April 2009, 6.

<sup>128</sup> Raz (n 109) 214-15.

<sup>129</sup> Raz (n 109) 215.

<sup>130</sup> Shaw, Slemrod and Whiting (n 49) 21. See also Evans (2008) (n 127) 9.

time than on subsequent occasions.’<sup>131</sup> In a 2006 study commissioned by HMRC on the tax administrative burdens on UK businesses, KPMG identified the burden created by changes to the tax legislation as a key theme that emerged from its work and one worth further study.<sup>132</sup>

‘Change creates both cost and uncertainty. There is a strong theme that much of tax administration works reasonably well once it is certain and has been around for long enough for business to set up a smooth machine to deal with the administrative requirements. What causes either actual or perceived increased costs is change that interferes with the smooth machine. One example is the frequent change in detailed legislation or, indeed, the introduction of new areas of legislation.’

The Meade Committee was particularly conscious of transitional issues, arguing that an important criterion in judging a new tax proposal was not merely the quality of the system once in operation, but also the ease or difficulty in making the transition from the old regime to the new.<sup>133</sup> The Committee repeatedly, and rightly, emphasised the importance of stability in the tax structure so that business and individuals could plan their affairs with confidence for the future,<sup>134</sup> citing the axiom that ‘an old tax is a good tax’.<sup>135</sup> Nevertheless, the UK tax system has undergone much change in the 30 years

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<sup>131</sup> Shaw, Slemrod and Whiting (n 49) 21. The authors also argue that stability is helped where the legislation is properly drafted the first time.

<sup>132</sup> KPMG, *Administrative Burdens – HMRC Measurement Project* (20 March 2006) <<http://www.hmrc.gov.uk/better-regulation/kpmg1.pdf>> accessed 30 March 2009, 5-6. One limitation of the KPMG study (besides that it examined burdens on businesses as opposed to taxpayers as a whole) is that it did not attempt to quantify some major forms of compliance costs including dealing with change and understanding which tax obligations are relevant: see Shaw, Slemrod and Whiting (n 49) 32-33 and Highfield (n 123) 12-13.

<sup>133</sup> Meade Report (n 13) 22.

<sup>134</sup> Meade Report (n 13) 5.

<sup>135</sup> Meade Report (n 13) 22.

since the Meade Report.<sup>136</sup> Constant political tinkering has played a role, but so has what Evans calls the ‘complication’ process—the pursuit of initiatives designed to simplify but that have only served to make the UK tax system, at its technical, operational and administrative levels, yet more complicated.<sup>137</sup> The result has been that the annual tax handbooks of legislation have doubled in size since 1997.<sup>138</sup> The reform proposals put forward later in this thesis will be especially sensitive to transitional issues.

Finally, any reforms to address income splitting in family businesses must avoid placing undue administrative burdens on small business. Compliance costs fall disproportionately on small businesses because they lack the expertise and economies of scale of larger firms who are able to employ administrative departments and outside advisors.<sup>139</sup> Of particular concern are rules that require a large number of small

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<sup>136</sup> The changes are summarised in Adam, Browne and Heady (n 90) 10-30; see also Evans (2008) (n 127) 2-5. (‘Reviewing the changes that have occurred in the UK tax system since Meade, there is certainly a sense in which there has been an abundance of activity’). Evans goes on to conclude that ‘whilst plentiful changes have taken place affecting tax rates and structure, the tax burden and the broad tax mix and tax base have remained essentially unaltered over the period’.

<sup>137</sup> Evans (2008) (n 127) 5-10. Interestingly, although the Tax Law Rewrite Project in particular has added to the volume of tax legislation, Evans takes the view that it has improved the comprehensibility of the legislation.

<sup>138</sup> In 1996 John Avery Jones observed that the income tax, corporations tax and capital gains tax legislation alone had grown from 1,467 pages of primary and secondary legislation in 1970 to over 6,000 pages. He concluded ‘There is no reason to suppose that the legislation will not continue to grow. In ten years from now we could be looking at 10,600, 13,500 or 19,000 pages at these rates of growth’: see John F Avery Jones, ‘Tax Law: Rules or Principles?’ [1996] BTR 580, 583. Given that the 1997 edition of Tolley’s Yellow Tax Handbooks of legislation and HMRC guidance comprised two volumes and the 2008 version has doubled in size to four volumes, Jones’s concerns over future growth were indeed well-founded. See also Evans (2008) (n 127) 7.

<sup>139</sup> Crawford and Freedman (n 94) [VI.2.2.1]; Meade Report (n 13) Appendix 22.1. Slemrod argues that the regressive cost burden on small business is offset by greater non-compliance on average by small businesses compared to employees: see Joel Slemrod, ‘Small Business and the Tax System’ in H Aaron and J Slemrod (eds) *The Crisis in Tax Administration* (Brookings Institution Press, Washington DC 2004). Crawford and Freedman as well as Gentry counter that there is unlikely to be a correlation between the tax savings of non-compliers and those who are burdened most with compliance costs: see William Gentry, ‘Comment on Small Business and the Tax

businesspersons to spend time and money working through complicated legislation for self-assessment purposes only to learn that the rules do not apply to them or that the rules do apply but the tax liability involved is negligible. Such a situation creates a great deal of taxpayer resentment for little gain.<sup>140</sup>

In summary, ease and cost of administration and compliance are important considerations in the context of income splitting in family businesses. The choice of tax unit, and rules governing acceptable and unacceptable income-splitting arrangements must be capable of being administered without undue complexity and cost, bearing in mind the potentially significant number of taxpayers involved and that it is not easy (nor perhaps socially desirable to any great extent) to police transactions within the family generally, nor family businesses in particular. The transitional impact of any new rules should also be minimised as far as possible.

### C. CONCLUSION

The traditional criteria of good tax design—equity, efficiency, certainty and ease of administration—considered in this Chapter provide the basic policy framework for the remaining Chapters of this thesis. A tax system’s approach to choice of tax unit, rules attributing income to taxpayers, and income splitting generally and in the family business

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System’ in H Aaron and J Slemrod (eds) *The Crisis in Tax Administration* (Brookings Institution Press, Washington DC 2004).

<sup>140</sup> Shaw, Slemrod and Whiting (n 49) 20. This form of complexity is another key theme identified by KPMG in its study of the tax administrative burden on UK businesses: KPMG (n 132) 6.

are all scrutinised against this framework, as are the current UK approach and possible reforms.

As will become evident, in analysing these issues the criteria of tax design will sometimes point in the same direction whilst on other issues they will conflict. How the trade-off between competing principles should be made in such circumstances will be the matter of some debate. Generally it is equity considerations, however, and more particularly horizontal equity, that are most prominent in, and central to, the income-splitting debate. Horizontal equity arguments arise time and time again—in the debate over tax unit (eg the treatment of married versus unmarried couples), the levels of tax on unearned (capital) income versus earned (labour) income, the attribution of both kinds of income to taxpayers, and the tax treatment of employees / self-employed persons / small companies engaged in similar economic activities. Even the optimal tax theory approach advocated by Banks and Diamond concedes a significant role for horizontal equity considerations,<sup>141</sup> although Kaplow would disagree.

This concession, however, does not go far enough for Kay, and rightly so. He argues that an optimal tax theory approach subject to equity limitations is completely the wrong way to approach tax design: ‘One should begin by seeking a measure of taxable capacity, with the measurement of taxable capacity constrained by administrative and

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<sup>141</sup> Banks and Diamond (n 34) 10. This conclusion is justified on the grounds of administrative and political feasibility: ‘One would need a great deal of faith in the political process not to want some protections against arbitrary tax assessments under the guise of “better taxation”’.

operational issues and by considerations of efficiency.’<sup>142</sup> The Carter Commission similarly concluded:<sup>143</sup>

‘The first and most essential purpose of taxation is to share the burden of the state fairly among all individuals and families. Unless the allocation of the burden is generally accepted as fair, the social and political fabric of a country is weakened and can be destroyed....We are convinced that scrupulous fairness in taxation must override all other objectives where there is a conflict among objectives.’

Although equity is ultimately of paramount importance in the income-splitting debate, efficiency and incentive concerns are also prominent at times, such as in the choice of tax unit. The resulting conclusions sometimes accord with the result under horizontal equity (as in choice of tax unit) and sometimes they do not (as in the appropriate taxation of capital versus labour income). Certainty and administrative concerns also place important limitations on equity (as Kay acknowledges), particularly when it comes to the appropriate taxation of business income generated by the combined efforts of family members.

The next Chapter applies the principles of tax design to the choice of tax unit.

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<sup>142</sup> Kay (n 41) 14 and see also 7: ‘For the Meade Committee, as for most ordinary people, questions of fairness and taxable capacity would seem to be of critical importance—even exclusive importance—in determining the household tax base.’

<sup>143</sup> Carter Commission (n 13) Vol 1, 4.

## **CHAPTER THREE: CHOICE OF TAX UNIT**

### **A. INTRODUCTION**

The incentives for income splitting in the family are strongest when the tax unit is the individual rather than a spousal or family tax unit. Thus, choice of tax unit plays a fundamental role in determining the extent to which income splitting will be an issue for a tax system. In fact the choice of tax unit is the preliminary question—one cannot sensibly discuss income splitting and what to do about it until the basic tax unit has been determined. This Chapter applies the criteria of tax design considered in the previous Chapter to the choice of tax unit. Many of the issues and considerations raised in this Chapter are also relevant to the discussion of income attribution in the following Chapter.

Part B advances a conceptual discussion of individual versus spousal/family taxation and the implications for equity, neutrality, certainty and administrative aspects of the tax system. The discussion on choice of unit begins with a critical review of the history and current UK position on the tax unit. The UK and international tax literature on the tax unit is then analysed in order to determine whether the individual has indeed proved to be the best choice for tax unit in the UK income (and capital gains) tax system. The analysis addresses arguments for and against the individual as tax unit based on considerations including horizontal equity, progressivity, work incentives, marriage neutrality and couples neutrality. Recent developments internationally, in UK family law and also human rights law are considered.

Part C examines a potential middle-ground alternative: transferable personal allowances. Part D summarises and concludes.

## **B. CHOICE OF TAX UNIT**

Tiley calls the debate over the correct tax treatment of the family, and the tax unit in particular, ‘one of the most contentious issues in tax policy.’<sup>144</sup> Theoretically, the family may seem to be the most appropriate unit of taxation as the family is often regarded as the basic economic unit in society.<sup>145</sup> Families pool resources at least to some degree, though the actual extent and relevance of this claim is subject to debate.

If the family rather than the individual forms the tax unit then the incentives to split income amongst family members disappears.<sup>146</sup> In its response to legislation proposed by the UK Government in 2007 to address income-splitting arrangements involving family businesses (discussed later in this thesis<sup>147</sup> but in any event subsequently

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<sup>144</sup> Tiley (n 23) 168.

<sup>145</sup> Carter Commission (n 13) Vol 1, 17-19 and Vol 3, 123; David Oliver and Peter Harris, ‘Family Connections and the Corporate Entity: Income Splitting through the Family Company’ in Oliver and Harris (eds) *Comparative Perspectives on Revenue Law: Essays in Honour of John Tiley* (CUP, Cambridge 2008) 244, 246 (‘Any attempt to tax the individuals of a family seeks to draw artificial economic lines between people that pool economic resources’).

<sup>146</sup> See eg Carter Commission (n 13) Vol 1, 18 (‘We therefore recommend in this Report that the income of families should be aggregated and taxed as a unit on a separate rate schedule. The rules against income splitting could largely be withdrawn because splitting would have no significance’).

<sup>147</sup> Chapter 6; see text at n 897.

abandoned), the CIOT put forth a number of alternative proposals, including revisiting the individual as the choice of tax unit.<sup>148</sup>

‘Tax credits already look at the family unit. As a consequence, a couple is often far worse off under the tax credit system than are two separate individuals. There may be some merit in considering whether families should be treated again as a unit for tax purposes, either by election in or election out of this system.’

On the other hand, if sound tax policy reasons exist for adopting the individual rather than the family or spouses as the tax unit, then rules will be needed to assign income from various sources (eg employment, business, capital) to the ‘appropriate’ family member, and these assignments must be respected. Allowing unfettered income splitting amongst family members would undermine the choice of individual as tax unit. The tax system will need to have specific measures in place to inhibit such activities.

This section begins with a brief review of the history of independent taxation in the UK before moving on to reconsider the choice of tax unit in the UK income (and capital gains) tax regime in light of the criteria for tax design previously identified, particularly equity and neutrality. Much has been written on this subject, especially in the US. The optimal tax policy literature on choice of income tax unit, however, is relatively sparse.<sup>149</sup> Choice of tax unit was not addressed as a separate topic in the Mirrlees Review,

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<sup>148</sup> Chartered Institute of Taxation, ‘Income Shifting: A Consultation on Draft Legislation – Response by the Chartered Institute of Taxation’ (28 February 2008) <<http://www.tax.org.uk/showarticle.pl?id=6578>> accessed 16 June 2009, [4.10].

<sup>149</sup> Michael J Boskin and Eytan Sheshinski, ‘Optimal Tax Treatment of the Family: Married Couples’ (1983) 20 *J of Public Econ* 281; C Brett, ‘Optimal Nonlinear Taxes for Families’ (2006) *International Tax and Public Finance* 225; H J Kleven, C T Kreiner and Emmanuel Saez, ‘The Optimal Income Taxation Of Couples’ (2006) NBER Working Paper 12685; H Cremer, J Lozachmeur and P Pestieau, ‘Income Taxation of Couples and the Tax Unit Choice, (2007) *Core*

though Brewer, Saez and Shephard in their paper consider how the design of taxes and benefits affecting an individual should be affected by the presence of a co-resident partner or dependent children.<sup>150</sup> The authors conclude that deriving optimal tax results for couples is extremely complicated<sup>151</sup> and the limited studies to date make it difficult to reach definitive conclusions.<sup>152</sup> Nevertheless, the economic literature has much to add to the analysis of incentives/disincentives to marry and for secondary earners (primarily women) to work outside the home, as will be seen below.<sup>153</sup>

## 1. HISTORY OF INDEPENDENT TAXATION IN THE UK

From the inception of the UK income tax in 1799 until relatively recent times a married woman was assumed by the tax system to be a dependent of her husband, classified along with ‘incapacitated persons and idiots’ who could not handle their own tax affairs.<sup>154</sup> Given that a wife historically was viewed as part of her husband’s property, and no more

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- Discussion Paper No 2007/13; H J Kleven, C T Kreiner and Emmanuel Saez (2009), ‘Supplement To “The Optimal Income Taxation Of Couples”’ *Econometrica Supplementary Material* 77.
- <sup>150</sup> Mike Brewer, Emmanuel Saez and Andrew Shephard, ‘Means Testing and Tax Rates on Earnings’ in James Mirrlees and others (eds), *Reforming the Tax System for the 21st Century: The Mirrlees Review* (The Institute for Fiscal Studies, London 2008) <<http://www.ifs.org.uk/mirrlees/mrPublications>> accessed 30 March 2009, section 5.
- <sup>151</sup> Brewer, Saez and Shephard (n 150) 30.
- <sup>152</sup> Brewer, Saez and Shephard (n 150) 2. Kaplow examines the optimal taxation of the family at some length despite expressing the view that the distributive considerations are orthogonal to his primary focus: see Kaplow (n 25) 315. He ultimately concludes that the optimal allocation of tax obligations and transfer payments across different family types ‘poses a particularly subtle and challenging instance’ (413) and this is one area in which even qualitative results about the direction of optimal redistribution may depend on the form of social welfare function (317). In fact, Kaplow concludes that some social welfare functions may optimally favour redistribution from worse-off families to better-off families (316).
- <sup>153</sup> See text at n 297 and at n 372.
- <sup>154</sup> N A Barr, ‘The Taxation of Married Women’s Incomes–II’ [1980] BTR 478. For a comprehensive review of the history of husband and wife taxation in the UK until 1982 see Ann Nuala Brice, ‘The Tax Treatment of the Family Unit’ (PhD thesis, University of London 1982).

able to have income in her own right than, say, her husband's prize bull,<sup>155</sup> it is not surprising that when the income tax was introduced a married woman's income was aggregated with her husband's, with the sum taxed as his.<sup>156</sup> When capital gains tax was introduced in 1965, married persons living together were given one shared annual capital gains exemption, and losses of one spouse were automatically offset against gains of the other unless the spouses elected out of such treatment.<sup>157</sup> As a result, spousal income-splitting arrangements (and devices to counter them) were of little practical concern in the UK.

Moreover, when personal allowances were introduced for income tax in 1920, married men received more generous allowances than single men on the basis that bachelors had a greater taxable capacity than men with a wife to support.<sup>158</sup> The 'married man's allowance' was £225—or 1.67 times the £135 given bachelors. In addition, married men with working wives could claim a 'wife's earned income allowance'—equal

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<sup>155</sup> Barr (n 154) 478. According to Barr, the typical chapter heading in UK legal textbooks used to be 'Married Women and Lunatics'.

<sup>156</sup> Formerly ICTA 1970 s 37 and ICTA 1988 s 279. Brice characterises the regime as giving rise to two general rules—the rule of aggregation of income and the rule of husband's accountability: see Brice (n 154) 25. Brice concludes that the principle that a husband should return and account for his wife's tax was entirely consistent with the general treatment of her property under the law prior to 1882 pursuant to which a married woman had no separate personality at law. Moreover, aggregation was not of great importance because the income tax originally was proportional not progressive: see 27, 29-31.

<sup>157</sup> Finance Act 1965 s 17(5), later Capital Gains Tax Act 1979 s 44, repealed by Finance Act 1988 s 104 and Sch 14. For a detailed historical discussion on the application of capital gains tax to married couples see Brice (n 154) 274-86.

<sup>158</sup> Brice (n 154) 70-73. The married man's allowance replaced the short-lived 'wife's allowance' available to married men with taxable income below £800 from 1918 to 1920. The 1920 Royal Commission had put forward the taxable capacity justification for a more generous married man's allowance and had suggested slightly higher amounts—£250 compared to £150 for bachelors: see Brice (n 154) 71-72. The ratio of the married man's allowance to the single person's allowance fluctuated between 1.5 and 1.75 over the years.

to the single person's allowance—which was justified on the grounds that such men had less taxable capacity than men with stay-at-home wives.<sup>159</sup>

Thus, for much of its history the UK income tax system was rooted in the idea that a woman on marriage becomes dependent on her husband, who is then responsible for the welfare of his wife and family.<sup>160</sup> By 1978 the Meade Committee recognised that that idea was becoming less and less relevant with an increasing number of married women working outside the home coupled with changing social attitudes on the relationship between men and women.<sup>161</sup> Indeed, as social attitudes changed, the form in which the UK had adopted joint taxation of married couples (treating the income of a wife as that of her husband) came to be regarded as deeply offensive.<sup>162</sup> Pressures for reform were also linked to the fact that tax law was 'out of line' with the system of separation of property for married couples enacted by the 1882 Married Women's Property Act<sup>163</sup> and the further extension of married women's property and contractual

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<sup>159</sup> Brice (n 154) 73-79. A version of what became the wife's earned income allowance first appeared in 1894 for small incomes. The 1954 Royal Commission accepted the taxable capacity justification for providing higher personal allowances to married men with working wives. The Commission thought that the allowance was excessively generous, however, but it remained at the single person's amount until it was repealed in 1988: see Brice (n 154) 71-72.

<sup>160</sup> Meade Report (n 13) 377.

<sup>161</sup> Meade Report (n 13) 377.

<sup>162</sup> John Tiley, 'Tax, Marriage and the Family' (2006) 65 CLJ 289, 291. In 1982, Brice argued that by 1980 criticism of the aggregation rule had moved from primarily legal reasons (eg inconsistency with the 1882 changes to the married woman's property regime) to social ones: see Brice (n 154) 404. Brice concludes (at 597) that '...the retention of the aggregation rule cannot be defended and, as it perpetuates an injustice against married persons, should be repealed' and (at 612) '...the repeal of the principle of husband's accountability should also follow, making husbands and wives individually responsible for their own tax affairs'.

<sup>163</sup> Judith Freedman and others, *Property and Marriage: An Integrated Approach* (The Institute for Fiscal Studies, London 1988) 106; Brice (n 154) 44-45. The 1882 Act changed the property rights of married women by providing that all property acquired by a married woman after the passing of the Act was her separate property and that she could acquire, hold and dispose of the whole legal and beneficial estate without the concurrence of her husband: s 1(1). A wife's liability in contract

rights (and liabilities) under The Law Reform (Married Women and Tortfeasors) Act 1935.<sup>164</sup>

Over time, some significant procedural changes were made to respond to these changing attitudes, including giving a married woman the right to request to be assessed separately from her husband,<sup>165</sup> which did not affect the overall tax paid but provided some measure of privacy in her tax affairs, and, from 1971, allowing a married woman to be taxed separately on her earned income.<sup>166</sup> As a practical matter, this was worthwhile financially only where the couple's combined income was in excess of £28,484 and her earnings were at least £6,579 (in 1988-89).<sup>167</sup> A wife's income from savings was always taxed as if it were her husband's. Thus, (unlike the position today) no income tax benefits could be gained by splitting investment income, such as interest and dividends (including dividends paid on shares in a family company), between husband and wife.

Additional advances could have been made to further promote women's status and equality whilst still retaining joint taxation of married couples (or at least joint taxation of investment income), for example, by permitting couples to file a joint income

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and tort remained somewhat limited, which Brice concludes (at 44-45) could explain to some extent the tax system's adherence to aggregation and husband's accountability; however, the husband could from that point be unaware of his wife's income and yet liable to account for it and pay tax on it.

<sup>164</sup> Although the 1935 Act provided for married women to be treated in almost all respects as other persons, the income tax rules of aggregation and husband's accountability remained: Brice (n 154) 46-47.

<sup>165</sup> ICTA 1988 s 283 formerly ICTA 1970 ss 38-39. For a detailed discussion of the history and operation of separate assessment see Brice (n 154) 112-47.

<sup>166</sup> ICTA 1988 s 287. For a detailed discussion of the option for separate taxation of a wife's earnings see Brice (n 154) 147-66.

<sup>167</sup> Inland Revenue press release (15 March 1988), reproduced in [1988] BTR 525.

tax return in both their names as is currently the procedure in the US. Instead, the movement towards independent taxation of married persons began to slowly gather momentum.<sup>168</sup> The Royal Commissions of 1920 (the Colwyn Commission)<sup>169</sup> and 1954 (the Radcliffe Commission)<sup>170</sup> examined the aggregation of the income of husband and wife for income tax purposes as well as possible alternatives, but neither recommended change. In 1980 a Green Paper on ‘The Taxation of Husband and Wife’ was released, which considered the merits of independent taxation at some length, but also did not favour change.<sup>171</sup> This was followed in 1986 by another Green Paper entitled ‘Personal Tax Reform’, however, which proposed the introduction of a system of independent taxation of married couples. Husbands and wives would each have a separate personal allowance for both income and capital gains tax; in addition, one spouse would be able to transfer his or her unused allowances to the other spouse.<sup>172</sup> These proposals eventually led to the decision in 1988 to adopt independent taxation effective April 1990.

In his 1988 Budget speech, then Chancellor Nigel Lawson described the Government’s two objectives behind its decision: first, it gave married women the same privacy and independence in their tax affairs as everyone else, and second, it brought to

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<sup>168</sup> Brice finds little evidence of dissatisfaction with aggregation and husband accountability until after the introduction of the Married Women’s Property Act 1882, though this can also be explained by the fact that the income tax was proportional not progressive in the 19<sup>th</sup> Century and also that there was no income tax at all in the period 1816-1842: see Brice (n 154) 316-17.

<sup>169</sup> HMSO, ‘Report of the Royal Commission on the Income Tax’ (Cmd 615, 1920) [238-83]. See also Brice (n 154) 351-60 and 437-39.

<sup>170</sup> HMSO, ‘Second Report of the Royal Commission on the Taxation of Profits and Income’ (Cmd 9105, 1954) [113-21]. See also Brice (n 154) 361-71 and 439-40.

<sup>171</sup> HMSO, ‘Taxation of Husband and Wife’ (Cm 8093, 1980). See also Brice (n 154) 401-14 and 453-57.

<sup>172</sup> HMSO, ‘The Reform of Personal Taxation’ (Cmd 9756, 1986).

an end the way in which the tax system could penalise marriage.<sup>173</sup> Tiley describes the result as reflecting ‘the recent age of extreme individualism.’<sup>174</sup> Section 32 of Finance Act 1988 was the key implementing piece of legislation, providing that section 279 of ICTA 1988 (the provision treating the income of a woman living with her husband as his income for income tax purposes) ‘shall not have effect for the year 1990-91 or any subsequent year of assessment.’ Additional transitional rules including those governing personal allowances, certain elections, carrybacks of relief, and capital allowance balancing charges were also required,<sup>175</sup> and some changes were made to recast the taxing legislation in less masculine terms.<sup>176</sup> A ‘married couple’s allowance’ was introduced, replacing the married man’s allowance and set at an amount equal to the difference between the single allowance and the married man’s allowance; the result ensured that no married couple was worse off under the new regime.<sup>177</sup> From 2000-01, however, this allowance is available only to those couples where one partner had reached the age of 65 on or before 5 April 2000.<sup>178</sup>

Overall, the new system was designed to remove the sexism inherent in the old system of joint taxation, with as little change as possible to people’s actual tax

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<sup>173</sup> 15 HC Deb. vol 129 col. 997 (15 March 1988). See also Nigel Lawson, *The View from No. 11: Memoirs of a Tory Radical* (Corgi Books, London 1992) 881–87.

<sup>174</sup> Tiley (n 23) 162.

<sup>175</sup> These rules are discussed in HM Revenue & Customs, ‘Independent Taxation Manual’ (June 2006) <<http://www.hmrc.gov.uk/manuals/inmanual/in60.htm>> accessed 23 July 2008.

<sup>176</sup> HM Revenue & Customs, ‘Independent Taxation Manual’ (n 175) [IN75] and Judith Freedman, ‘Independent Taxation: Lion or Mouse?: Clauses 24, 31-34, 41, 93 and 98 and Schedule 3’ [1988] BTR 224.

<sup>177</sup> Bill Robinson and Graham Stark, ‘The Tax Treatment of Marriage: What has the Chancellor Really Achieved?’ (1988) 9 *Fiscal Studies* 48, 49.

<sup>178</sup> ITA 2007 ss 45-46.

payments.<sup>179</sup> As a result of married women receiving their own personal allowance which, unlike the old wife's earned income allowance, could be offset against income from any source including investment income, Dilnot estimated a million women with small amounts of investment income were taken out of the income tax system completely.<sup>180</sup>

Kerridge, in an article published just prior to the announcement of the 1988 changes, compared the income and capital tax treatment of a married couple with that of two single persons under the rules as they then applied.<sup>181</sup> Kerridge concluded that whilst most people were better off for income tax purposes married than single, for others it made no difference, and for others still (such as where the wife had substantial investment income) marriage made an unmarried couple worse off.<sup>182</sup> Although finding no rhyme or reason for such a result, Kerridge was especially critical of the income tax system for being generally so favourable to married couples rather than, for example, favouring couples with children.<sup>183</sup> In a follow-up article written after the 1988 Budget changes, Kerridge criticised the new regime for being even more generous to married couples, and reiterated his call to instead focus on support for couples with young children.<sup>184</sup> He also noted that the new rules, whilst undoubtedly simple, made no

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<sup>179</sup> Andrew Dilnot, Paul Johnson and Graham Stark, 'Savings, Independent Taxation and the 1990 Budget' (1990) 11 *Fiscal Studies* 27, 30.

<sup>180</sup> Dilnot, Johnson and Stark (n 179) 32-33.

<sup>181</sup> Roger Kerridge, 'Taxation and Marriage' (1988) 47 *CLJ* 77.

<sup>182</sup> Kerridge (n 181) 80.

<sup>183</sup> Kerridge (n 181) 81 ('Clearly it does not cost a couple more to live together than to live separately, so why should a married couple receive any tax privileges?').

<sup>184</sup> Roger Kerridge, 'Tax, Marriage and the 1988 Budget' (1988) 47 *CLJ* 477.

provision to guard against tax-motivated rearrangements of a couple's capital in order to arrive at the most fiscally advantageous split of investment income.<sup>185</sup> He suggested instead an aggregation of a couple's investment income combined with wider tax bands than those applicable to a single person;<sup>186</sup> this proposal (and others) is considered in Chapter 4.<sup>187</sup>

Thus, the joint taxation of husband and wife in the UK came to an end when Finance Act 1988 introduced independent taxation of married women, with effect from 6 April 1990. Thereafter, if one spouse is liable to tax at a lower rate than the other spouse, the couple's combined tax burden on a given level of combined income will vary depending on the proportion taxed in each spouse's hands. Some of the effects of the move to independent taxation are only now becoming apparent (and the subject of debate), including the extent to which income splitting is and should be permitted in the context of family businesses.

## **2. RE-EXAMINING CHOICE OF TAX UNIT**

Twenty years have now passed since the move to independent taxation of husband and wife in the UK. Some UK tax commentators have begun to question the wisdom of independent taxation and its role in encouraging family income-splitting arrangements. This includes the CIOT, as noted above,<sup>188</sup> and also Crawford and Freedman who argue

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<sup>185</sup> Kerridge (n 184) 478.

<sup>186</sup> Kerridge (n 184) 478, referring to his arguments in Kerridge (n 181) 94-97.

<sup>187</sup> Chapter 4, text beginning at n 528.

<sup>188</sup> Text at n 148.

in their paper on small businesses for the Mirrlees Review that to fully address the income-splitting advantages from using a spouse's personal allowance and lower tax bands in the context of family businesses 'it would be necessary to consider the nature of independent taxation of spouses and civil partners and the role of their personal allowances.'<sup>189</sup>

One aim of this Chapter is to explore and contribute to this debate on the choice of tax unit and the role of personal allowances. To that end, the next section begins with a critical review of the UK and international tax policy literature—in particular the extensive US literature—on choice of tax unit in order to determine whether the individual is indeed the best choice for tax unit in the UK income tax and capital gains tax systems. Recent developments in UK family law are instructive and considered at some length, and comparisons are drawn with the approach adopted by the US, Canada and other jurisdictions to the tax unit question. The analysis will address arguments for and against the individual as tax unit based on considerations such as horizontal equity, progressivity, autonomy and privacy, marriage neutrality, couples neutrality and work incentives. The focus will be on a spousal unit as the main alternative to the individual; however, the same arguments apply at least as equally to spouses as to families, if not more so.

### (a) Background

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<sup>189</sup> Crawford and Freedman (n 94) [III.3.2].

A recently published review of the OECD countries' income tax systems found that the individual is the most commonly used basic tax unit, adopted by 21 of the 30 countries.<sup>190</sup> Germany, the Czech Republic, Ireland, Luxembourg, Poland, Switzerland and the US either allow or require joint spousal taxation; only France and Portugal tax on a family unit basis that includes dependent children.<sup>191</sup> Under the French 'family quotient' system, a family's total taxable income is divided by a quotient determined by marital status and number of children.<sup>192</sup> This figure is then used to calculate each family member's tax using a standard rate schedule applied to the relevant quotient, and those tax amounts are totalled to arrive at a figure for the family.<sup>193</sup> Generally, the quotient for couples is 2 plus 0.5 for each of the first two children, rising to 1 for the third and further children.

Whilst in the US most married couples file and are treated as one joint tax unit, from its inception in 1913 until 1948 the US federal income tax treated spouses as two separate taxpayers.<sup>194</sup> This obviously created incentives for the shifting of income between the spouses, and income splitting by means of interspousal transfers of gifts became a well established, accepted and effective practice in the US so long as control

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<sup>190</sup> Jonathan R Kesselman, 'Income Splitting and Joint Taxation of Couples: What's Fair?' (2008) 14 IRPP Choices 1. Kesselman's study focused on the tax unit as applicable to the taxation of employment income – by far the largest component of income tax revenues in OECD countries. For an earlier study centred on European countries see Irene Dingeldey, 'European Tax Systems and Their Impact on Family Employment Patterns' (2001) 30 J Soc Pol 653, 658 Table 1.

<sup>191</sup> Kesselman (n 190) 15.

<sup>192</sup> Kesselman (n 190) 16-17.

<sup>193</sup> Kesselman (n 190) 17.

<sup>194</sup> This account of US tax history is primarily drawn from Lawrence Zelenak, 'Marriage and the Income Tax' (1994) 67 S Cal L Rev 339, 344-48, Edward J McCaffery, *Taxing Women* (University of Chicago Press, Chicago 1997) 29-85, Michael McIntyre and Oliver Oldman, 'Taxation of the Family in a Comprehensive and Simplified Income Tax' (1977) 90 Harvard L Rev 1573, and Boris I Bittker, 'Federal Income Taxation and the Family' (1975) 27 Stanford L Rev 1389, 1399-1414.

actually was relinquished over the assets.<sup>195</sup> The tax effectiveness of attempts to split earned income was less certain, until two decisions of the United States Supreme Court in 1930. In the first case, *Lucas v Earl*,<sup>196</sup> the Supreme Court ruled that income from employment could not be shifted from husband to wife in a common law separate property jurisdiction. Justice Holmes, delivering the opinion of the Court, stated:<sup>197</sup>

‘There is no doubt that the [Revenue Acts of 1918 and 1921] could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skilfully devised to prevent the salary when paid from vesting even for a second in the man who earned it.’

The Supreme Court’s holding in *Lucas v Earl* is referred to as the ‘assignment of income doctrine’, and has since been widely applied in the US to restrict income shifting.<sup>198</sup> Later in the same year, the Supreme Court decided in *Poe v Seaborn*<sup>199</sup> that in a community property state, half of the income earned by the husband was the income of the wife for federal income tax purposes.<sup>200</sup> This was despite the fact that whilst each spouse had a present interest to one-half of the community income, the husband was vested with the

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<sup>195</sup> Bittker (n 194) 1401-3. At 1401 Bittker notes: ‘[T]axpayers wanting to shift the tax liability for investment income to their spouses or children found it possible to do so with impunity, if they were prepared to give up ownership of the underlying securities, bank account, rental real estate, or other property.’

<sup>196</sup> 281 US 111 (1930).

<sup>197</sup> *Lucas v Earl* (n 196) 114-15.

<sup>198</sup> Stafford Smiley and James Motter, ‘The US Perspective: Income Splitting’ (10 July 2008) 162 Taxation 40.

<sup>199</sup> 282 US 101 (1930).

<sup>200</sup> *Poe v Seaborn* (n 199).

exclusive right to manage the community property free from any duty to account for his stewardship while the marriage lasted.<sup>201</sup>

Following the decision in *Poe v Seaborn*, a number of separate property states adopted some form of community property solely in an attempt to reduce their residents' taxes.<sup>202</sup> In addition, husbands in those states that remained separate property states attempted self-help income splitting, through both gifts of property and by making their wives business partners.<sup>203</sup> In response to these developments, the US Congress provided for automatic income splitting between spouses as a matter of federal income tax law in 1948. Interestingly, but not unexpectedly, all of the states which had adopted community property after *Poe v Seaborn* quickly changed back to separate property systems.

Thus, it is apparent from the response to the decisions in *Lucas v Earl* and *Poe v Seaborn* that the primary reason for the 1948 move to effectively a spousal tax unit for US federal income tax purposes was geographical equalization between common law and separate property jurisdictions, along with the desire to reduce incentives to enter into income-splitting arrangements.<sup>204</sup> The main beneficiaries were married couples, and particularly married men in a traditional one-earner family who could enjoy the tax savings from full income splitting with their wives without having to actually to give

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<sup>201</sup> Bittker (n 194) 1404-8.

<sup>202</sup> Stanley Surrey, 'Federal Taxation of the Family – The Revenue Act of 1948' (1948) 61 Harvard L Rev 1097, 1104.

<sup>203</sup> Zelenak (n 194) 345.

<sup>204</sup> Zelenak (n 194) 346.

their wives a share of their property.<sup>205</sup> Surrey, one of the key architects of the 1948 reforms, went so far as to applaud the changes for encouraging women to stay at home, writing that women could now ‘turn from their partnership “duties” to the pursuit of homemaking’.<sup>206</sup> Bachelors, spinsters, opposite-sex cohabitants who chose not to marry, same-sex couples who did not even have the opportunity to choose, widows and widowers, all saw their tax burden increase, though this ‘singles penalty’ was later reduced in 1969 when changes were made to the rate schedules.<sup>207</sup> In any event, as Zelenak points out, what is now the standard justification for the US joint tax system—that a couple acts as an economic unit by pooling its resources, and should be taxed accordingly—was developed only as an after-the-fact rationalisation.<sup>208</sup>

Unlike the US, most OECD countries and most common-law countries, including Australia, New Zealand and South Africa, have adopted the individual as the tax unit for income tax purposes. Similarly, from the inception of the Canadian income tax in 1917, the basic unit of tax has been the individual. The 1966 Carter Commission favoured the family over the individual as the tax unit.<sup>209</sup> The Carter Commission was heavily influenced by US theorists, particularly Oldman and Temple,<sup>210</sup> but those recommendations were never adopted in Canada. Entitlement to the refundable good and services tax credit (designed to mitigate the regressive nature of the Canadian value

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<sup>205</sup> McCaffery (n 194) 52-54.

<sup>206</sup> Surrey (n 202) 1111.

<sup>207</sup> McCaffery (n 194) 62-64.

<sup>208</sup> Zelenak (n 194) 347.

<sup>209</sup> Carter Commission (n 13) Vol 1, 17-19 and Vol 3, 123.

<sup>210</sup> Oliver Oldman and Ralph Temple, ‘Comparative Analysis of the Taxation of Married Persons’ (1960) 12 *Stanford L Rev* 585.

added tax) under section 122.5 of the Canadian Income Tax Act 1985<sup>211</sup> (CITA), however, is determined on the basis of a couple's combined income.<sup>212</sup> Eligible taxpayers may also claim a spousal tax credit, though the amount of the credit is gradually reduced in line with the taxpayer's spouse's income until it fully disappears once the spouse earns in excess of approximately CAN\$8,000.<sup>213</sup> Older taxpayers with insufficient taxable income also can transfer certain personal age and pension income tax credits to a spouse if the credits otherwise could not be used.<sup>214</sup> Similarly, a student can transfer unused tuition, education and textbook tax credits to his or her spouse.<sup>215</sup> Interestingly, from 2008, pension income can now be split between spouses. Statutory anti-avoidance rules attempt to limit spousal splitting of investment income, however, as will be discussed further in Chapter 4.<sup>216</sup>

In summary, whilst the individual is the most common tax unit internationally, and the choice in the UK since 1990, spousal and family units are also used in some jurisdictions, including the US. Thus, there is no international consensus on choice of tax unit. The next section begins the examination into the merits and disadvantages of individual and spousal/family units.

## (b) Definitional Issues

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<sup>211</sup> RSC 1985, c 1 (5th Supp).

<sup>212</sup> CITA s 122.5.

<sup>213</sup> CITA s 118(1)(a).

<sup>214</sup> CITA ss 118(2), (3) and 118.8. See also Canada Revenue Agency, *Interpretation Bulletin IT-513R* (24 February 1998) [34].

<sup>215</sup> CITA ss 118.5, 118.6(2), 118.6(2.1) and 118.8.

<sup>216</sup> Chapter 4; see text at n 543.

If the tax unit is anything other than the individual, this immediately raises difficult definitional issues. Who is a ‘spouse’? Should a joint tax unit apply only to married couples or should it include same-sex couples who have entered into some form of legally-recognised registered partnership? Can cohabiting but unmarried/unregistered couples qualify as spouses? If so, for how long must they have cohabited before qualifying for spousal treatment? Should it matter for this purpose whether the couple have a sexual relationship? Could economically interdependent siblings or friends ever qualify for treatment as a ‘couple’? Where should the boundary line be drawn?

An even more problematic question is what constitutes a ‘family’? Choosing the family as the tax unit raises all the difficulties associated with defining a spousal unit, and then some. Obviously a decision has to be made on who to include in the family unit—spouses (however defined) and minor children, of course, but what about stepchildren, children spending time in two homes, adult children living with their parents or attending university, and elderly relatives living with their children? Oliver and Harris go so far as to suggest a family company could be considered part of a family tax unit.<sup>217</sup> Once the family unit has been determined, the next challenge becomes designing an appropriate rate schedule / quotient system.

In the interest of focusing the debate, the analysis that follows is confined primarily to the particular issues faced in defining a spousal tax unit, though the

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<sup>217</sup> Oliver and Harris (n 145) 246.

arguments raised for and against a joint tax unit will generally apply at least as well if not more so to a family unit.<sup>218</sup>

*(i) Background*

The first issue in defining a spousal unit for tax purposes is whether it should include cohabiting unmarried couples (including same sex couples) as well as married couples. For purposes of joint filing under the US income tax, ‘spouse’ means married spouse.<sup>219</sup> In the UK, for income, capital gains and inheritance tax purposes ‘spouse’ also means husband or wife, and in some cases they also must be living together to enjoy special tax treatment.<sup>220</sup> With effect from December 2005, the Civil Partnership Act extended the treatment of married couples under the UK personal income tax to include registered same-sex couples. During the course of the debate on the Civil Partnership Bill in the House of Lords an amendment was adopted to further extend the availability of civil partnerships to family members if (i) they were over 30 years of age; (ii) they had cohabited for at least 12 years; and (iii) they were not already married or in a civil

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<sup>218</sup> For example, identifying who is and who is not within a ‘family’ and taking into account individuals joining and leaving the family tax unit would be much more difficult than if a spousal unit was used: see Oliver and Harris (n 145) 245-46.

<sup>219</sup> Internal Revenue Code, s 1(a).

<sup>220</sup> See, eg, TCGA 1992 s 58, pursuant to which transfers of property can be made between spouses and civil partners on a ‘no gain / no loss’ basis so long as the spouses are living together.

partnership with some other person. The amendment was reversed, however, when the Bill returned to the House of Commons.<sup>221</sup>

From a definitional point of view, the individual as tax unit has the advantage of being a bright-line test, and thus easy to administer. Adopting any other unit (eg spouses, family, household) and the test becomes greyer. As Bittker notes, sociologists may find it useful to study groups that engage in joint decision-making or that manifest a common interest in the economic well-being of their members, but it is difficult if not impossible to administer a tax law that employed ‘such squishy phrases’.<sup>222</sup> In defining a spousal tax unit, the easiest and less ‘squishy’ option is to use a formal test such as marriage and civil registration (such as for same-sex partnerships). Although marriage and civil registration provides a legally precise definition, such precision will inevitably exclude groups that are only marginally different, so far as relevant economic or social relationships are concerned, from those within the definition.<sup>223</sup> If married couples are taxed on their consolidated income, for example, is it not horizontally equitable to extend similar treatment to couples cohabitating together on a long-term basis in a ‘common law marriage’?

McIntyre and Oldman, advocates of the ‘benefit rule’ pursuant to which persons are taxed on income which they enjoy without regard for their property interests, state

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<sup>221</sup> House of Commons Library Research Paper 04/64, ‘The Civil Partnership Bill [HL]: Background and Debate’ (7 September 2004) <<http://www.parliament.uk/commons/lib/research/rp2004/rp04-064.pdf>> accessed 31 July 2008, 29-43.

<sup>222</sup> Bittker (n 194) 1398.

<sup>223</sup> Bittker (n 194) 1399. See also Neil Brooks, ‘The Irrelevance of Conjugal Relationships in Assessing Tax Liability’ in John G Head and Richard Krever (eds) *Tax Units and the Tax Rate Scale* (Australian Tax Research Foundation, Sydney 1996) 63.

that unmarried persons who pool their income should theoretically be entitled to use some form of income splitting for tax purposes just as with married couples.<sup>224</sup>

‘These persons will be disadvantaged if income splitting is limited to the marital unit, and such a limitation is inconsistent with the ideal to tax each person on the real benefits he derives from income.’

Despite the theoretical attractiveness of extending the treatment accorded married couples to unmarried persons who pool their income, McIntyre and Oldman nevertheless conclude that for ‘administrative reasons’ pooling for tax purposes should not be available to unmarried persons.<sup>225</sup> Bittker similarly takes the position that the tax authorities would be faced with ‘formidable problems’, requiring an unacceptable degree of invasion of taxpayer privacy if one is tempted to substitute ‘social realities’ in defining the boundaries of the group whose income is to be consolidated.<sup>226</sup> Importantly, McIntyre and Oldman go on to qualify their conclusions by stating that should income pooling amongst unmarried persons become a common feature of society, then the income tax ideal they espouse may have to face up to this, by developing, for example, a fiscal definition of marriage that includes marriage-type relationships.<sup>227</sup> Later writing on his own McIntyre backtracked to a certain extent, arguing that a bright line needs to be drawn somewhere, though again he goes on to concede that policymakers could extend a

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<sup>224</sup> McIntyre and Oldman (n 194) 1597.

<sup>225</sup> McIntyre and Oldman (n 194) 1597.

<sup>226</sup> Bittker (n 194) 1399.

<sup>227</sup> McIntyre and Oldman (n 194) 1597-98.

joint system to ‘unmarried sex partners’ if they wanted, though of course administrative problems would arise.<sup>228</sup>

Unfortunately for advocates of joint taxation, unmarried cohabitants indeed have become a sizable and growing segment of modern society, and in areas such as the tax credit system and family law are no longer being ignored in the UK. Recent reports from the Law Commission<sup>229</sup> and the Tax Law Review Committee of the Institute for Fiscal Studies<sup>230</sup> highlight the increasing trend toward unmarried cohabitation in the UK. Whilst marriage remains the main form of partnership between women and men in the UK,<sup>231</sup> because the marriage rate has been declining and marriage is being deferred until later in life, the number of unmarried cohabiting couples has increased dramatically since the 1970s and is expected to continue to increase.<sup>232</sup> Over the last twenty years, the proportion of unmarried men and women aged under 60 cohabiting in Great Britain rose from 11 per cent of men and 13 per cent of women to 24 per cent and 25 per cent

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<sup>228</sup> Michael McIntyre, ‘Marital Income Splitting in the Modern World: Lessons for Australia from the American Experience’ in John G Head and Richard Krever (eds) *Tax Units and the Tax Rate Scale* (Australian Tax Research Foundation, Sydney 1996) 1, 8.

<sup>229</sup> Law Commission, ‘Cohabitation: The Financial Consequences of Relationship Breakdown’ (Law Com No 307 Cm 7182, 2007) [1.6-1.13].

<sup>230</sup> Tracey Bowler, *Taxation of the Family* (The Institute for Fiscal Studies, London 2007) 2-4.

<sup>231</sup> Office of National Statistics, *Social Trends* 38 (2008)  
<[http://www.statistics.gov.uk/downloads/theme\\_social/Social\\_Trends38/Social\\_Trends\\_38.pdf](http://www.statistics.gov.uk/downloads/theme_social/Social_Trends38/Social_Trends_38.pdf)>  
accessed 28 July 2008, 20.

<sup>232</sup> Bowler (n 230) 2 and Law Commission (n 229) [1.8] citing data from the Office of National Statistics *Social Trends Survey* for 2006 and 2007.

respectively.<sup>233</sup> Similarly, the number of cohabiting couple households with dependent children more than doubled between 1991 and 2001.<sup>234</sup>

This is also reflected in the increasing rate of births in the UK to parents who are not married. By 2006, 43.7 per cent of all births in the UK occurred outside marriage, compared with 25.2 per cent in 1988; much of this increase was the result of increasing numbers of births to cohabiting parents.<sup>235</sup> Moreover, unmarried cohabitation is expected to become increasingly common in the UK and to spread across a wider range of the population in terms of age. The UK Government Actuary's Department has predicted that by 2031 the number of cohabiting couples in England and Wales will have increased to 3.8 million.<sup>236</sup> On this projection, over one in four couples will be cohabiting by 2031; 16% of adults will be in cohabiting relationships and 41% married.<sup>237</sup> The Law Commission also notes that just as cohabitation has been increasing, so too has its public acceptance. In the British Social Attitudes survey 2000, 67% of respondents agreed that it was 'all right for a couple to live together without intending to get married'.<sup>238</sup>

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<sup>233</sup> Office of National Statistics (n 231) 19.

<sup>234</sup> Law Commission (n 229) [1.9].

<sup>235</sup> Office of National Statistics (n 231) 24.

<sup>236</sup> Law Commission (n 229) [1.10], citing the principal projections of the Government Actuary's Department, *Marital Status Projections for England and Wales* (2005).

<sup>237</sup> Law Commission (n 229) [1.10], citing the principal projections of the Government Actuary's Department, *Marital Status Projections for England and Wales* (2005).

<sup>238</sup> Law Commission (n 229) [1.11], citing A Barlow, S Duncan, G James and A Park, 'Just a Piece of Paper? Marriage and Cohabitation' in A Park, J Curtice, K Thomson, L Jarvis and C Bromley (eds), *British Social Attitudes: Public Policy, Social Ties. The 18th Report* (Sage, London 2001) Table 2.2.

It is clear from this statistical evidence that even focusing on the most straightforward choice for a non-individual tax unit—a joint spousal tax unit—a large number of people may be in or out of the defined joint unit depending on whether and to what extent unmarried cohabitants are included. The increased prominence of cohabitation evident from the statistics just cited cast serious doubts on the viability and desirability of a strict definitional adherence to marriage. Even if the decision is made to define the joint unit in such a way as to include this significant and growing proportion of the UK population, the next question becomes how precisely to define which cohabitants are in and which are not; the group comprising unmarried cohabitants is far from homogeneous.<sup>239</sup> Reference to fairly recent development in UK tax credits and family law, as well the Canadian approach, is instructive in this regard; these are considered next.

*(ii) Current UK Tax and Tax Credit Approach to Unmarried Cohabitants*

Whilst the UK income and capital gains tax systems for the most part distinguishes between unmarried couples, on the one hand, and married couples (and more recently registered same sex civil partners) on the other, for purposes of the Child Tax Credit and Working Tax Credit the Government's policy is to treat certain unmarried cohabitants in the same way as married couples and registered civil partners.<sup>240</sup> Tax credits are calculated by reference to the circumstances of the 'family' and 'couple', and 'couple' is

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<sup>239</sup> Discussed in more detail below: see text at n 263.

<sup>240</sup> The tax credit systems are described in Bowler (n 230) and Natalie Lee (ed), *Revenue Law—Principles and Practice* (25<sup>th</sup> edn Tottel Publishing, West Sussex 2007) [51.29-.41].

defined to include spouses and registered civil partners as well as unmarried/unregistered couples 'living together as husband and wife' or civil partners.<sup>241</sup>

The HMRC guidelines on Child Tax Credits<sup>242</sup> lists the following factors they consider relevant in determining whether an unmarried couple is living together as husband and wife: (i) Membership of the same household, (ii) stability of the relationship, (iii) lifetime bond not essential, (iv) financial support, (v) sexual relationship, (vi) how other people see the relationship, and (vii) start and end of relationship. As a starting point, a couple are unlikely to be found to be living together as husband and wife unless they live in the same household, which seems reasonable enough. It is also a 'strong pointer' to a husband and wife relationship if they call themselves 'Mr and Mrs'.<sup>243</sup> If it has been established at some point that the couple were living together as husband and wife it will be easier to argue that their relationship continues.<sup>244</sup> Interestingly, although sexual relationship has been an important criteria in the past and is listed by HMRC in the guidelines as one factor to consider, the guidelines then go on to state that the couple's sexual relationship 'is of little help' in deciding the matter because some marriages lack a sexual component and sexual relationships occur outside marriage without any indication that the parties wish to live together as husband and wife.<sup>245</sup> Obviously the HMRC guidelines will not always be easy to apply; one needs

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<sup>241</sup> Tax Credits Act 2002 s 3(5A).

<sup>242</sup> Set out in Bowler (n 230) Appendix I.

<sup>243</sup> Bowler (n 230) Appendix I.

<sup>244</sup> Bowler (n 230) Appendix I.

<sup>245</sup> Bowler (n 230) Appendix I.

to know quite a bit about the couple in order to weigh up all these factors, which inevitably requires a significant intrusion into the couple's lives.

One might conclude that the tax credit definition including couples 'living together as husband and wife' could also be used for income tax, as the CIOT suggested should be considered.<sup>246</sup> At first glance it appears inconsistent to use an individual unit for income tax and a joint unit for tax credits. Moreover, tax-credit like treatment has crept into the employment tax context in recent years in rules aimed at tax avoidance. For example, for purposes of the 'managed service company' rules in Part 2, Chapter 9 of ITEPA—aimed at addressing tax-motivated attempts to disguise employment through the use of intermediaries—'a man and a woman living together as husband and wife are treated as if they were married to each other'<sup>247</sup> and 'two people of the same sex living together as if they were civil partners of each other are treated as if they were civil partners of each other'.<sup>248</sup>

There is no normative inconsistency, however, in using an individual tax unit for income tax purposes and basing transfer payments (including those delivered in the form of a tax credit) on family income. As Brooks argues, tax credits aimed at relieving poverty in working families and families with children are 'quite sensibly' based upon

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<sup>246</sup> Text at n 148.

<sup>247</sup> ITEPA s 61(4).

<sup>248</sup> ITEPA s 61(5). As Bowler observes, unlike the equivalent tax credit test, the ITEPA test goes on to add that 'two people of the same sex are to be regarded as living together as if they were civil partners if, but only if, they would be regarded as living together as husband and wife were they instead two people of the opposite sex': Bowler (n 230) 16.

some function of consumption instead of control of income.<sup>249</sup> Moreover, basing transfer payments on family income does not imply full sharing of family resources, only that the low-earning partner in a one-earner family is not likely ‘in need’ if the other partner earns a high income.<sup>250</sup> Finally, it likely is not administratively feasible to use the transfer payment structure for purposes of the positive tax system; social programs require a high level of expensive, intensive and intrusive auditing, particularly around the economics of a claimant’s living arrangements.<sup>251</sup> Social support is by its nature intrusive, as the State has to understand the claimant’s situation and needs in order to arrive at an appropriate response that addresses those needs. None of this is inherently necessary for a tax, even one levied on ability to pay. Tax is a burden the State is imposing on a large percentage of the population as opposed to needs-based assistance the State is providing to a much smaller group; to attempt to apply a social support structure to the income tax would be very difficult and very costly.<sup>252</sup>

### *(iii) The UK Family Law Approach*

A very different approach from the tax credit policy has been taken in the UK in the family law context. Whilst the majority of the general public believe unmarried cohabitants who have been together for a period of time are treated under the law just like

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<sup>249</sup> Brooks (n 223) 78.

<sup>250</sup> Brooks (n 223) 78.

<sup>251</sup> Brooks (n 223) 78.

<sup>252</sup> Brooks (n 223) 78.

married couples on the breakdown of their relationship or death of one of the partners,<sup>253</sup> the reality is quite different. Experts refer to this as the ‘myth of common law relationships’.<sup>254</sup> In the case of married couples, the court has very wide powers under Part 2 of the Matrimonial Causes Act 1973 to deal with the property of the couple on their divorce in order to arrive at a broadly fair outcome for the parties. Outcomes are determined based on the ‘sharing’ and ‘needs’ principles.<sup>255</sup> The MCA 1973 does not apply to unmarried cohabitants, even where the cohabitants have lived together for many years and have children together. Instead, financial arrangements on the separation of unmarried cohabitants are determined in accordance with a somewhat bewildering patchwork of primarily general laws, including contract, property, resulting trust, constructive trust and proprietary estoppel, and, indirectly, under laws aimed at protecting the interests of children.<sup>256</sup>

Furthermore, unlike a spouse, a cohabitant has no automatic entitlement to any share of his or her partner’s estate on intestacy.<sup>257</sup> A cohabitant must ask a court for an award under the Inheritance (Provision for Family and Dependants) Act 1975 where he or she has not obtained reasonable financial provision from the deceased’s estate. In order to be eligible, he or she must have cohabited with the deceased for the last two years of

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<sup>253</sup> A Barlow and others, ‘Cohabitation and the Law: Myths, Money and the Media’ (2008) <<http://www.law.ex.ac.uk/news/documents/CohabitationFindingsbooklet.pdf>> accessed 28 July 2008, 1-2. The authors found that the majority who still falsely believe cohabitation gives the same legal rights as marriage has reduced to 51% from 56% since 2000 with the proportion of cohabitant believers falling from 59% to 53%.

<sup>254</sup> Barlow and others (n 253) 1.

<sup>255</sup> Law Commission (n 229) [C.2].

<sup>256</sup> See schedule 1 to the Children Act 1989.

<sup>257</sup> Law Commission (n 229) [6.5].

the deceased's life.<sup>258</sup> An applicant who does not qualify as a 'cohabitant' within the IPFDA 1975 definition still may be able to claim under the general heading of a 'dependant' of the deceased.<sup>259</sup>

Beginning in 2005, the UK Law Commission undertook a review of the legal rights of unmarried/unregistered cohabitants.<sup>260</sup> The Law Commission study defined 'cohabitation' as people who are not married to each other or who have not formed a civil partnership living together 'in relationships bearing the hallmarks of intimacy and exclusivity'. The project concentrated in particular on the family law and inheritance issues surrounding cohabitation, including whether cohabitants should have access to any remedies from one party to the other when they separate and whether where a cohabitant dies without a will (intestate) the surviving partner should have automatic rights to inherit (as is currently provided to surviving spouses).<sup>261</sup> Unfortunately, the Law Commission did not consider tax issues in order to keep the project 'manageable' in scope, and because the Department for Constitutional Affairs suggested that tax considerations would not address the most immediate policy needs.<sup>262</sup> Nevertheless, the Law Commission's findings shed some light on the topic at hand.

In its final report issued in July 2007, the Law Commission concluded that cohabitants should *not* be treated the same way as married couples due to 'the broad

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<sup>258</sup> Law Commission (n 229) [6.1-6.2].

<sup>259</sup> Law Commission (n 229) [6.14].

<sup>260</sup> Law Commission, 'Cohabitation Project' <<http://www.lawcom.gov.uk/cohabitation.htm>> accessed 24 July 2008.

<sup>261</sup> Law Commission. 'Cohabitation Project' (n 260).

<sup>262</sup> Law Commission. 'Cohabitation Project' (n 260).

range of cohabiting relationships, exhibiting different degrees of commitment and interdependence'.<sup>263</sup> Some are similar to marriage, whilst others are quite dissimilar. Moreover, the Law Commission thought it important that cohabitants had not made 'the distinctive legal and public commitment that marriage entails'.<sup>264</sup> Instead, the Law Commission developed a scheme for cohabitants entirely separate from the regime applicable to married couples on divorce or death.

Under the proposed scheme, formerly-cohabiting partners could apply for relief after the breakdown of the relationship where certain eligibility criteria were met. The Law Commission suggested cohabitants would be eligible if they had children together or if they lived together for a period ranging from two to five years (leaving the actual period to be chosen by government). This of course illustrates the difficult definitional issues discussed earlier. The Law Commission proposed a non-exhaustive checklist<sup>265</sup> to assist in the eligibility determination based on six signposts from social security law and also used by HMRC in its guidance on tax credits (listed above).<sup>266</sup> Interestingly, the Law Commission thought that sexual relationship was an important factor, unlike the HMRC.<sup>267</sup> Furthermore, the Law Commission recommended the IPFDA 1975 be amended so as to provide the same definition of 'cohabitant' as that used to define eligibility to apply under their proposed scheme for financial relief on separation, except

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<sup>263</sup> Law Commission 'Cohabitation: The Financial Consequences of Relationship Breakdown—Executive Summary' (Law Com No 307 (Summary), 2007) [1.10].

<sup>264</sup> Law Commission (n 229) [4.5-4.8 and C.6].

<sup>265</sup> Law Commission (n 229) [3.19].

<sup>266</sup> Text at n 242.

<sup>267</sup> Law Commission (n 229) [3.21], citing *Re J (Income Support: Cohabitation)* [1995] 1 FLR 660, 666.

keeping the two year minimum living together requirement.<sup>268</sup> An applicant also would need to prove that he or she had made ‘qualifying contributions to the relationship giving rise to certain enduring consequences’ at the point of separation. Cohabitants would have the ability to opt-out of the scheme by agreement.

The Law Commission’s proposals are controversial. The Government’s initial response has been to do nothing and wait for the results of research into the operation of provisions in the Family Act (Scotland) 2006 analogous to those proposed by the Law Commission so that the Government could extrapolate from those results what the likely costs and benefits to the entire UK would be.<sup>269</sup> In December 2008, however, Liberal Democrat peer Lord Lester introduced a Private Member’s Cohabitation Bill in the House of Lords, which closely follows the Law Commission’s report in that it sets up a separate legislative framework for cohabitants with two years as the requisite period of cohabitation (on the low end of the Law Commission’s suggested range of between two and five years).<sup>270</sup> The Bill had second reading on 13 March 2009 and at the time of submission of this thesis was still in the committee stage.

In any event, neither the Law Commission’s report nor the Cohabitation Bill are put forward here as an answer to the definitional issues surrounding the choice of a spousal tax unit, but rather they are indicative of the lack of consensus in the UK on the

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<sup>268</sup> Law Commission (n 229) [6.16].

<sup>269</sup> Justice Minister Bridget Prentice ‘Response to Paper on Cohabitation and Relationship Breakdown’ (6 March 2008) <<http://www.justice.gov.uk/news/announcement060308a.htm>> accessed 24 July 2008.

<sup>270</sup> Cohabitation Bill (2008-09 HL-8).

treatment of cohabitants generally. Whilst the Law Commission's proposed definition appears fit for purpose, as with the tax credit definition it is unlikely to be administratively feasible for an annual income tax applied to the population as a whole. Moreover, tax policy makers most likely do not have the easier option the Law Commission and the Cohabitation Bill chose of creating a new, specially-tailored regime for cohabitants, separate from that applicable to married couples. At least some difference in treatment on death or separation can arguably be justified on the basis of the different legal forms of relationship, eg the equal sharing of property on divorce flowing from the marriage contract, versus an approach modelled on sharing economic disadvantages arising from the relationship for cohabitants who chose not to marry. For tax, if the idea of a joint unit means first and foremost that the couple should be treated as an economic unit, with their income aggregated and then subject to one set of tax rates and allowances, then either it makes sense to aggregate or it does not.

It is possible to add another defined category to the existing rules applicable to spouses, as was the case with civil partnerships; that is, not to modify the definition of spouse to include cohabitants but rather amend all the rules to read 'spouse or civil partner or statutory cohabitant.' This approach is less politically charged and also reflects the actual relationship choices made by the couples as to the legal structure of their relationship, which the Law Commission thought important.<sup>271</sup> But that is probably as far as one could go. Any other choice is difficult to justify on a principled basis and would mostly likely end up in a great deal of duplication if it were attempted. Moreover,

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<sup>271</sup> Text at n 263.

running two parallel but slightly different systems (one for spouses/civil partners and one for statutory cohabitants) invariably invites comparisons between the two, and claims of unfair treatment for whichever group was less favourably treated in a particular situation.

*(iv) The Canadian Approach*

Unlike the current situation in the US and UK income tax law, and in marked contrast to the approach currently taken in the UK family law context as well as the Law Commission proposals, in Canada married couples and common law partners (including same-sex partners) cohabiting in a conjugal relationship are treated in the same way for income tax purposes. Note the requirement of ‘conjugal relationship’—the parties must have a sexual relationship; it is not merely one factor among many that are considered. It should also be noted that the Civil Marriage Act 2005 extended the definition of marriage under Canadian law to include same-sex marriages.<sup>272</sup>

The Canadian Income Tax Act (CITA) adopts the phrase ‘spouse or common law partner’ to effect this equivalent treatment between married and unmarried partners. A ‘common law partner’ is defined in section 248(1) of the CITA as, with respect to a taxpayer at any time, a person who cohabits at that time *in a conjugal relationship* with the taxpayer and

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<sup>272</sup> The CITA consequently was amended to remove in the definition of ‘spouse’ the requirement that spouses be of the opposite sex: CITA s 252(1), (3) as amended by SC 2005, c 33, s 12. For a list of the consequential amendments to the ITA and other federal statutes following the enactment of the Civil Marriage Act 2005 see Department of Justice Canada, ‘Civil Marriage Act’ (February 2005) <[http://www.justice.gc.ca/en/news/nr/2005/doc\\_31376.html](http://www.justice.gc.ca/en/news/nr/2005/doc_31376.html)> accessed 19 June 2007.

(a) has so cohabited with the taxpayer for a continuous period of at least one year, or

(b) is the natural or adoptive parent (legal or in fact) of a child of the taxpayer.

Just as the relevance of a couple's sexual relationship is debatable for purposes of determining if a man and a woman are living together as husband and wife for the UK tax credit legislation, the Canadian income tax 'conjugal relationship' requirement has been heavily criticised by Canadian tax commentators including Young,<sup>273</sup> primarily on privacy and autonomy grounds. Brooks also takes the position that removing provisions in the tax legislation conditioned on a taxpayer's conjugal relationship would go part way to eliminating the patriarchal model upon which much of the Canadian tax legislation is premised.<sup>274</sup>

Notwithstanding those criticisms, support for a Canadian income tax-style approach that treats at least some unmarried cohabitants equally with married couples can be found in a recent UK sociological study. The study found that whilst some people continue to view marriage and cohabitation very differently and think the law should make clear distinctions, this view loses its force the more a relationship exhibits 'marriage-like' qualities.<sup>275</sup> According to the study's authors, public opinion (and that of cohabitants) does not in the main expect the law to distinguish between married and cohabiting couples in terms of the financial provision remedies available on breakdown

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<sup>273</sup> Claire F L Young, *What's Sex Got to Do With It? Tax and the Family* (Law Commission of Canada, Ottawa 2000).

<sup>274</sup> Brooks (n 223) 79.

<sup>275</sup> Barlow and others (n 253) 4.

where there are children of the relationship, in longer term relationships or where there is evidence of a joint enterprise (such as working together in a business).<sup>276</sup> Unlike the Law Commission, the study found that most people consider that cohabitants should have the same claims on death as a widow/widower.<sup>277</sup>

#### *(v) Summary*

In summary, whether to include cohabitants in a spousal tax unit, and if so how to precisely define those cohabitants who fall within the joint unit are thorny issues. The easiest to administer option is to exclude cohabitants entirely. Excluding cohabitants and relying instead on a legal threshold such as marriage and registered partnership has the advantage of definitional certainty. This approach gives rise to horizontal inequity, however, by excluding a large (and growing) number of taxpayers who many would argue are similarly situated in so far as ability to pay. On the other hand, if cohabitants are included in the joint unit, the unit becomes less certain to define and would inevitably still exclude some cohabitants close to the definitional line (eg a couple who have lived together one year and 11 months as of 5 April). It also risks damaging the institution of marriage, an issue that the Law Commission did its utmost to sidestep, whilst at the same time demeaning some cohabitants by treating them as married even though they have deliberately decided marriage was not for them.

#### **(c) Relationship Neutrality and Personal Autonomy**

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<sup>276</sup> Barlow and others (n 253) 4.

<sup>277</sup> Barlow and others (n 253) 4.

Assuming a spousal tax unit could be adequately defined, is it a good idea to do so? Adopting a spousal unit creates incentives for individuals to become, or not become, a joint unit purely for tax reasons. It also raises privacy and personal autonomy concerns. These considerations are examined next.

*(i) Incentive Effects*

An issue that frequently arises in the debate on choice of tax unit is whether the tax system should provide incentives to marry or not to marry—the ‘marriage neutrality’ question.<sup>278</sup> The tax system is marriage neutral if it provides no more favourable treatment for married couples compared to others (no ‘marriage bonuses’) and is also no less favourable to married couples compared to others (no ‘marriage penalties’). One of the reasons cited by then Chancellor Lawson for the introduction of independent taxation in the UK was to avoid marriage penalties.<sup>279</sup> It is noteworthy that the Chancellor was not arguing for marriage neutrality, just the absence of marriage penalties.

Traditionally in the UK (and many other jurisdictions) the tax system has been used to encourage marriage over other forms of relationships as a matter of public policy, and political support for marriage as an institution still exists: the Conservative Party recently confirmed that tax relief for married couples is one of the priorities of a

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<sup>278</sup> See eg 1920 Royal Commission (n 169) [254]; 1954 Royal Commission (n 170) [117]; 1980 Green Paper (n 171) [4(b)]; Meade Report (n 13) 377, criteria 1; Brice (n 154) 592.

<sup>279</sup> See text at n 173.

Conservative Government.<sup>280</sup> In a newspaper interview, Shadow Chancellor George Osborne argued that marriage is essential to building a strong society and was critical of the Labour Government for stopping supporting marriage through the tax system.<sup>281</sup> Similar statements have been made by Conservative Party leader David Cameron.<sup>282</sup> It is not clear if the Conservative Party planned to extend tax benefits to civil partners as well—it was not mentioned in the interviews—though it is difficult not to do so given the present income tax framework.

A legitimate purpose of the tax system is as a tool of social policy. Advancing social objectives, however, often will conflict with other objectives such as neutrality and equity. Some might say that balancing these competing objectives is a question for public opinion and politicians to answer, within the confines of constraints such as human rights legislation. Nevertheless, the criteria of tax design can provide some insight. If the tax unit is the individual then for the most part it should not make a difference to his or her tax situation whether he or she was single, cohabiting, or married. If the tax unit is instead a spousal unit, defined as a married couple / civil partners—but not cohabitants—

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<sup>280</sup> ‘Tory Tax Breaks in Blueprint for Stronger Families’ *Daily Telegraph* (London 4 July 2009) <<http://www.telegraph.co.uk/news/newstopics/politics/conservative/5737684/Tory-tax-breaks-in-blueprint-for-stronger-families.html>> accessed 6 July 2009 (‘The proposals would give married couples tax relief worth thousands of pounds a year...’); R Winnett, ‘Tories Promise Tax Breaks for Married Couples’ *Daily Telegraph* (London 23 August 2008) <<http://www.telegraph.co.uk/news/newstopics/politics/conservative/2604297/Tories-promise-tax-breaks-for-married-couples.html>> accessed 23 August 2008.

<sup>281</sup> Winnett (n 280).

<sup>282</sup> A Porter, ‘Married Couples Victims of “Mad” Government Policies, Says David Cameron’ *Daily Telegraph* (London 2 January 2009) <<http://www.telegraph.co.uk/news/newstopics/politics/4076132/Married-couples-victims-of-mad-Government-policies-says-David-Cameron.html>> accessed 5 January 2009.

then it may be beneficial or detrimental, depending on the circumstances, to become another's spouse.<sup>283</sup>

The Law Commission also noted in its cohabitation study that many participants in the debate about the legal and fiscal support provided for families, and the ways in which welfare benefit and tax policy might be used to encourage or discourage particular family forms, take the position that marriage should be supported on the basis that research studies have shown that marriage is often associated with the best outcomes for children.<sup>284</sup> The positive effect of marriage on children is one of the main arguments advanced by the Church of England in its calls for active government support for marriage<sup>285</sup> and the primary rationale underlying the Conservative Party's support for tax benefits for marriage. Others argue that it is more important to support children in whatever family form they are raised.<sup>286</sup>

The Law Commission considered what impact, if any, the law (and especially family law) has on the decision to marry. According to the Law Commission, research suggests that even where individuals are provided with accurate information about their

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<sup>283</sup> Bowler (n 230) 5-6.

<sup>284</sup> Law Commission (n 229) [2.36].

<sup>285</sup> John Sentamu, Archbishop of York, 'Give Parents a Living Wage to Stay at Home' *Sunday Times* (London 24 June 2007)  
<[http://www.timesonline.co.uk/tol/comment/columnists/guest\\_contributors/article1976769.ece](http://www.timesonline.co.uk/tol/comment/columnists/guest_contributors/article1976769.ece)>  
accessed 24 September 2009 ('Children do better when their parents are married. The beneficial impact of marriage upon children in terms of wellbeing, mental health, educational attainment and antisocial behaviour benefits us all as a society. It remains appropriate, therefore, that the laws of our country reflect this and that the support for marriage offered by the state in a legislative framework should not only remain intact but, more importantly, should actively support marriage'.).

<sup>286</sup> Law Commission (n 229) [2.36]; Kerridge (n 181) 81 and Kerridge (n 184) 477.

legal position, ‘the law may have relatively little effect on what people do: in particular, in deciding whether to start or end a relationship, and whether to cohabit or to marry or register a civil partnership.’<sup>287</sup> Granted, this does not specifically consider tax bonuses and penalties, but it is reasonable to assume that the general public’s understanding of tax law is no greater than their appreciation of the family law consequences, especially since studies have shown that the majority of the population (as well as the majority of cohabitants) believe that cohabitants are entitled to the same legal rights as married couples—the myth of common law marriage mentioned above.<sup>288</sup> Recent research has also found that some cohabitants think that it is wrong to take on what they view as the serious commitment of marriage for legal or financial reasons.<sup>289</sup>

It is apparent from its report and proposal for a separate regime that the Law Commission was careful to avoid any criticism that its proposals undermined marriage. It defended itself against such criticisms by arguing that respect for the unique status of

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<sup>287</sup> Law Commission (n 229) [2.42], citing R Tennant, J Taylor and J Lewis, *Separating from Cohabitation: Making Arrangements for Finances and Parenting* (2006) Department for Constitutional Affairs Research Report 7/2006, 139; M Hibbs, C Barton and J Beswick, ‘Why Marry? – Perceptions of the Affianced’ (2001) 31 *Family Law* 197; J Eekelaar and M Maclean, ‘Marriage and the Moral Bases of Personal Relationship’ (2004) 31 *J of Law and Society* 510; A Carling, S Duncan and R Edwards (eds), *Analysing Families: Morality and Rationality in Policy and Practice* (2002); C Smart and P Stevens, *Cohabitation Breakdown* (2000) p 50; J Lewis, ‘Marriage, Cohabitation and the Law: Individualism and Obligation’ and J Lewis, J Datta and S Sarre, ‘Individualism and Commitment in Marriage and Cohabitation’ (1999) Lord Chancellor’s Department Research Series Nos 1/99 and 8/99.

<sup>288</sup> See text at n 253.

<sup>289</sup> Law Commission (n 229) [2.42], citing A Barlow, C Burgoyne, J Smithson, *The Living Together Campaign – An investigation of Its Impact on Legally Aware Cohabitants* Ministry of Justice Research Report (forthcoming, 2007), chapters 4 and 5. British Social Attitudes survey 2000 found that just 9% of the public agreed that ‘There’s no point getting married - it’s just a piece of paper’ indicating the high social value that continues to be attached to marriage: A Barlow, S Duncan, G James and A Park, ‘Just a piece of paper? Marriage and cohabitation’, in A Park, J Curtice, K Thompson, L Jarvis and C Bromley (eds), *British Social Attitudes: Public Policy, Social Ties. The 18th Report* (2001).

marriage was a major reason why their proposals did not treat cohabitants the same as married couples.<sup>290</sup> The Law Commission also cited statistical evidence from Australia indicating that similar reforms introduced there had no impact on marriage rates.<sup>291</sup> Nevertheless, it was still subject to criticism by supporters of the institution of marriage. In a comment representative of many opponents of the Law Commission's proposals, Jill Kirby of the Centre for Policy Studies criticised the plans as introducing a 'kind of marriage lite':<sup>292</sup>

'If a man and a woman want to create a family together, then the most durable contract available to them is marriage....If they decide not to marry, then I think consequences must flow from that, and that if we introduce... a kind of substitute version, as the Law Commission proposes, then it does detract from that institution and I think will lead to more confusion.'

The importance or lack thereof of marriage neutrality in tax has been debated extensively in the US tax policy literature. Critics of the current structure of the US personal income tax have argued that one's marital status should not affect the amount of tax one pays.<sup>293</sup> Furthermore, McCaffery takes the position that arguments against marriage penalties are generally just a way for upper-income families to argue for and get tax relief.<sup>294</sup> Zelenak argues that a comparison of tax liabilities between a married couple and two single people, on which marriage neutrality analysis depends, can be dismissed as irrelevant. That comparison does not matter, because it is not a comparison of similarly-situated

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<sup>290</sup> Law Commission (n 229) [4.2-4.10].

<sup>291</sup> Law Commission (n 229) [2.43].

<sup>292</sup> BBC News, 'Cohabiting Law Changes Proposed' (31 July 2007) <<http://news.bbc.co.uk/1/hi/uk/6923373.stm>> accessed 28 July 2008.

<sup>293</sup> Zelenak (n 194) 371.

<sup>294</sup> McCaffery (n 194) 19.

taxpayers—the married couple is fundamentally different from the two single people, because the couple forms one economic unit, while the two single people do not. McIntyre and Oldman, on the other hand, are opposed to basing the choice of tax unit on marriage neutrality because it abandons what they call the well-established feature of the US tax system since 1948 that couples with equal income should be taxed equally.<sup>295</sup> As previously noted, however, this feature is not a principled aim of the US income tax but rather an after-the-fact justification for the present state of affairs.<sup>296</sup>

Finally, the Law Commission’s conclusion that the tax consequences of marriage have little impact on the decision to marry finds support in recent economic studies. Brewer, Saez and Shephard note that although the marriage penalty/subsidy attracts substantial public attention, it becomes relevant for optimal taxation only if the decision to marry is sensitive to those fiscal incentives.<sup>297</sup> Hoynes, in her commentary on the Brewer, Saez and Shephard paper, examines the US and UK data on marriage penalties and subsidies.<sup>298</sup> She concludes that marriage is sensitive to the financial incentives

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<sup>295</sup> McIntyre and Oldman (n 194) 1589.

<sup>296</sup> Text at n 208.

<sup>297</sup> Brewer, Saez and Shephard (n 150) 29. On this point, Kaplow concludes that a scheme that is ideal on distributive grounds is likely to influence marriage decisions, which favours reducing the differentiation to an extent that depends on the pertinent elasticity. The possibility that marriage and divorce entail externalities, however, also needs to be considered: see Kaplow (n 25) 342.

<sup>298</sup> Hilary Hoynes, ‘Commentary on Brewer, Saez and Shephard, “Optimal Household Labor Income Tax and Transfer Programs: An Application to the UK”’ in James Mirrlees and others (eds), *Reforming the Tax System for the 21st Century: The Mirrlees Review* (The Institute for Fiscal Studies, London 2008) <<http://www.ifs.org.uk/mirrlees/mrPublications>> accessed 30 March 2009, 7.

inherent in welfare systems, but that ‘the estimated elasticities with respect to the tax-induced financial incentives to marry (and divorce) are small’.<sup>299</sup>

In summary, the evidence suggests few people take into account the possibility of a marriage bonus or penalty when deciding to get married, and, in any event, marriage neutrality may be more desirable on policy grounds. This is discussed further in the next section.

### *(ii) Relationships, Equality, Autonomy and Privacy*

According to then Chancellor Lawson, one of the Government’s main objectives in adopting independent taxation in 1988 was to give married women the same privacy and independence in their tax affairs as others.<sup>300</sup> Because a husband was accountable under joint taxation for his wife’s income, it was necessary for her to disclose information about her income to him. The rules did not, of course, require a wife to know the details of her husband’s income. All correspondence as regards a wife’s income tax was sent to her husband.<sup>301</sup> This situation was very unpopular with wives.<sup>302</sup> Furthermore, the need for a wife to disclose even a small ‘nest egg’ saved up for a special purpose for which her

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<sup>299</sup> Hoynes (n 298) 7-8.

<sup>300</sup> See text at n 173.

<sup>301</sup> Brice (n 154) 419.

<sup>302</sup> Equal Opportunities Commission, *Income Tax & Sex Discrimination* (Manchester 1979) 19-20 (‘Perhaps the most common complaint made by married women about their tax position concerns the Inland Revenue’s practice of conducting correspondence with the husband only...It may be suggested that such complaints are trivial. But what many married women object to is the assumption that they do not exist as far as the Inland Revenue is concerned’).

husband may not have approved was reported to have led to much distress for wives.<sup>303</sup>

Husbands could also legitimately complain about a system imposing on them a duty to declare and pay tax on income of which they may not even be aware let alone benefit from.<sup>304</sup>

For these reasons Brice in 1982 and Freedman and others in 1988 concluded that there was a considerable desire amongst both husbands and wives for some degree of privacy within marriage with respect to tax affairs.<sup>305</sup> The Equal Opportunities Commission also expressed dissatisfaction with the tax system in the late 1970s over similar privacy concerns.<sup>306</sup> The UK's experience is in keeping with the experience in other jurisdictions. Lahey conducted a comparative study of tax jurisdictions and concluded that joint tax unit models tend to be replaced by individual models as relationships recognized in law 'become more diverse, as sex roles become more

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<sup>303</sup> Freedman and others (n 163) 114; Equal Opportunities Commission (n 302) 21-22.

<sup>304</sup> This point is raised by eg the Radcliffe Commission in HMSO, 'Final Report of the Royal Commission on the Taxation of Profits and Income' (Cmd 9474, 1955) [1060] ('It is one of the necessities of the present system that a husband is required to make and sign a return of the income of himself and his wife but he has no means of knowing precisely what his wife's income is ...'). The Commission recommended that a wife be obliged to sign her husband's tax return in order to verify the accuracy of those statements in it that relate to her income. Brice argues that this recommendation was unpopular because it would have meant that wives for the first time would have a right to see details of their husbands' income: (n 154) 440. See also Equal Opportunities Commission (n 302) 20.

<sup>305</sup> Brice (n 154) 441-46 and 610-12; Freedman and others (n 163) 114. Freedman and others raised concerns over the ability of the then Inland Revenue to enforce a husband's duty to pay tax on income of which he might not even be aware.

<sup>306</sup> Equal Opportunities Commission (n 302) 19-22.

egalitarian, as social values become less “traditional”...[and] as women gain direct legal interests in income and assets....’<sup>307</sup>

In a relatively small number of cases, litigants have even tried to argue before the European Court of Human Rights that tax legislation providing different (and usually less favourable) treatment to married couples as compared to unmarried couples in otherwise similar circumstances was discriminatory and infringed the European Convention for the Protection of Human Rights and Fundamental Freedoms 1950.<sup>308</sup> This is obviously a much more difficult case to make out than merely describing the tax system as ‘unfair’ for providing more favourable tax treatment for taxpayers in one form of relationship rather than another, and this difficulty has been reflected in the high hurdle applicants have faced.

The discrimination cases primarily have been brought under a combination of Article 1 of the First Protocol of the Convention (‘Article 1/1’), which protects the enjoyment of property, and Article 14, which prohibits discrimination in the enjoyment of the rights protected by the Convention. Taxation is a prima facie interference with the right to enjoy property; however, the drafters of the Convention provided a specific exception for taxation in the second paragraph of Article 1/1. Nevertheless, according to Baker, as an exception to a fundamental right, taxation is subject to supervision by the

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<sup>307</sup> Kathleen A Lahey, *The Benefit/Penalty Unit in Income Tax Policy: Diversity and Reform* (Law Commission of Canada, Ottawa 2000) 25.

<sup>308</sup> Philip Baker, ‘Taxation and the European Convention on Human Rights’ [2000] BTR 211, 213. As Baker describes, in addition to Article 14, these cases have also sought to challenge the provisions of the tax legislation on grounds including Article 8 (right to respect for private and family life) and Article 12 (the right to marry).

Strasbourg organs ‘to ensure that taxation is imposed according to law, that taxation measures pursue a legitimate purpose and that the means employed are not disproportionate to the ends involved.’<sup>309</sup>

For the most part the ECHR has not been sympathetic towards taxpayers in these cases; States have enjoyed a wide margin of appreciation in taxation matters.<sup>310</sup> For example, in *Lindsay v UK*,<sup>311</sup> the taxpayers were a married couple. The husband had both earned and unearned income; the wife only unearned income. Under the tax rules then in place, in this situation the wife’s unearned income was aggregated with her husband’s income for income tax purposes, and her husband was eligible for the married man’s allowance equal to one and one-half times the usual personal allowance. An unmarried cohabiting couple in the same situation was entitled to two personal allowances, and on the facts, paid less total tax. The taxpayers claimed the UK tax legislation discriminated against them as a married couple.<sup>312</sup> The European Commission Human Rights rejected their claim on the basis that married and unmarried couples are not in comparable situations:<sup>313</sup>

‘The applicants in the present case seek to compare themselves, a married couple, with a man and woman who receive the same income, but who

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<sup>309</sup> Baker (n 308) 220.

<sup>310</sup> Baker (n 308) 213; see also Philip Baker, ‘Taxation, Human Rights and the Family’ in Oliver and Harris (eds) *Comparative Perspectives on Revenue Law: Essays in Honour of John Tiley* (CUP, Cambridge 2008) 232, 243.

<sup>311</sup> (App no 11089/84) (1986) 49 DR 181.

<sup>312</sup> The taxpayers also unsuccessfully claimed discrimination on the grounds of sex (they would have paid less tax under the then rules if she had been the breadwinner), and religion (they were married in a church).

<sup>313</sup> *Lindsay v UK* (n 311) 559-60.

live together without being married. The Commission is of the opinion that these are not analogous situations. Though in some fields, the de facto relationship of cohabitantes is now recognised, there still exist differences between married and unmarried couples, in particular, differences in legal status and legal effects. Marriage continues to be characterised by a corpus of rights and obligations which differentiate it markedly from the situation of a man and woman who cohabit. The Commission accordingly concludes that the situation of the applicants is not comparable to that of an unmarried couple and that part of the application therefore does not enclose any appearance of a violation of Prot. No. 1 Art. 1 read in conjunction with Art. 14 of the Convention....’

The special status of marriage was again emphasised in the recent case of *Burden and Burden v UK*.<sup>314</sup> In *Burden* two elderly sisters unsuccessfully challenged the UK’s spousal rollover for inheritance tax treatment as discriminatory. The sisters had lived together their entire lives and for over 30 years in a house they jointly-owned that had been built on land inherited from their parents. Each sister had made a will leaving all her property to the other. The value of each sister’s assets (including the share of the house) was well in excess of the IHT nil rate band. As sisters, they would be unable to take advantage of the IHT spousal exemption that allows the property of one spouse to be transferred to the other spouse without incurring an IHT charge.<sup>315</sup> Instead, on the death of one of the sisters, the surviving sister would be faced with a large inheritance tax bill, perhaps requiring her to sell the house to pay the tax.

The ECHR in Grand Chamber rejected the sisters’ claim. In comments reminiscent of the stance adopted by the Law Commission, the Grand Chamber

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<sup>314</sup> (App no 13378/05) [2008] STC 1305.

<sup>315</sup> IHTA 1984 s 18.

emphasised the special status of the institution of marriage (and civil partnership), stating:<sup>316</sup>

‘[T]he Grand Chamber notes that it has already held that marriage confers a special status on those who enter into it. The exercise of the right to marry is protected by Article 12 of the Convention and gives rise to social, personal and legal consequences.... In *Shackell* [v the United Kingdom (dec.), no. 45851/99, 27 April 2000], the Court found that the situations of married and unmarried heterosexual cohabiting couples were not analogous for the purposes of survivors’ benefits, since ‘marriage remains an institution which is widely accepted as conferring a particular status on those who enter it’. The Grand Chamber considers that this view still holds true.’

The Grand Chamber then discussed the particular situation of the two siblings:<sup>317</sup>

‘Just as there can be no analogy between married and Civil Partnership Act couples, on one hand, and heterosexual or homosexual couples who choose to live together but not to become husband and wife or civil partners, on the other hand..., the absence of such a legally binding agreement between the applicants renders their relationship of cohabitation, despite its long duration, fundamentally different to that of a married or civil partnership couple....’

The Grand Chamber concluded that the applicants, as cohabiting sisters, cannot be compared for the purposes of Article 14 to a married couple or civil partnership. From that conclusion, it followed that there had been no discrimination and, therefore, no violation of Article 14 taken in conjunction with Article 1/1.<sup>318</sup>

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<sup>316</sup> *Burden and Burden v UK* (n 314) [63].

<sup>317</sup> *Burden and Burden v UK* (n 314) [65].

<sup>318</sup> *Burden and Burden v UK* (n 314) [66].

In 2000 Baker commented on the lack of success of married taxpayers claiming discrimination, and speculated that unmarried cohabitants in otherwise similar situations as married couples may have more success:<sup>319</sup>

‘This may be an area where a dynamic approach to the interpretation of the Convention eventually recognises that couples (both heterosexual and, perhaps, homosexual) who live in a stable and settled relationship should be accorded the same tax treatment as a married couple.’

Given the Grand Chamber’s strongly-worded holding in *Burden and Burden* this does not seem likely to be the case. One exception can be found in the case *PM v UK*.<sup>320</sup> In *PM* the applicant had cohabited for about ten years with Miss D, but they never married. They had a daughter together and the applicant was registered as her father. When the couple separated, he undertook pursuant to a Deed of Separation to make weekly maintenance payments for his daughter. Under the then UK tax rules, such payments were deductible for income tax purposes, but only where the couple had been married. The Court stated:<sup>321</sup>

‘This is not a situation where the applicant seeks to compare himself to a couple living in a subsisting marriage..., but one where the married father has separated or divorced and is also living apart from the child of the family. Other persons, not parents, are not covered by the child support provisions and are generally in a different situation. This applicant differs from a married father only as regards the issue of marital status and may, for the purposes of this application, claim to be in an relevantly similar position....’

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<sup>319</sup> Baker (n 308) 252.

<sup>320</sup> (App no 6638/03) (2006) 42 EHRR 45.

<sup>321</sup> *PM v UK* (n 320) [27-28].

Given that he has financial obligations towards his daughter, which he has duly fulfilled, the Court perceives no reason for treating him differently from a married father, now divorced and separated from the mother, as regards the tax deductibility of those payments. The purpose of the tax deductions was purportedly to render it easier for married fathers to support a new family; it is not readily apparent why unmarried fathers, who undertook similar new relationships, would not have similar financial commitments equally requiring relief.’

Thus, whilst in general it is unlikely that differential tax treatment of married and unmarried couples will be a human rights violation, in the right fact pattern a case can be made out.

Regardless of the present situation under human rights law, it remains possible for taxpayers and tax policy commentators to argue that the tax system is violating horizontal equity when it treats otherwise similarly-situated married couples differently from unmarried cohabitants. For example, whilst the two elderly sisters in *Burden and Burden* may have been unsuccessful in their claim of discrimination the Grand Chamber referred to excerpts from the House of Lords debate on the Civil Partnership Bill. In that debate, peers from the three main political parties expressed concerns over the IHT treatment for siblings who share a home and carers who look after disabled relatives.<sup>322</sup>

Despite the approach adopted by the Conservative Party, and in contrast to the basic rationale underlying the ECHR decisions just discussed, some commentators argue that tax systems take into account a taxpayer’s relationships (particularly marriage) to too

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<sup>322</sup> *Burden v Burden* (n 314) [20], referring to the House of Lords amendment to the Civil Partnership Bill (later reversed when the Bill returned to the House of Commons) to allow siblings and others to register to enjoy the same IHT benefits: discussed above at n 221.

great an extent at the expense of individual autonomy.<sup>323</sup> Although the UK has adopted the individual as tax unit for income and capital gains tax purposes, in many cases the taxpayer's marital status will have some bearing on his or her tax situation.

Commonly, anti-avoidance provisions are extended to include spouses in order to stop what is otherwise an obvious and easy way to circumvent the measures in question. One example is in the managed services company provisions mentioned earlier.<sup>324</sup> Another example relates to the small companies' rate of corporation tax. This relief reduces the usual rate of corporations tax from 28% to 21% on the first £300,000 of profits. It is relatively easy to multiply the benefit of this relief simply by dividing a business amongst many companies all controlled by the same person. For that reason, the benefit of the relief must be shared amongst companies controlled by the same person and, furthermore, for purposes of determining if a company is controlled by a person, the definition of 'associate' includes the person's spouse.<sup>325</sup> If spouses were not so included, it is easy for a taxpayer to at least double the benefit of the small companies relief simply by transferring half the business to a company controlled by his or her spouse. The difficulty with such rules is that they can be over-inclusive; a company owned by one spouse is automatically deemed associated with a company controlled by the other spouse even in cases where the two companies are involved in completely different trades, have no business dealings, and no tax avoidance purpose is present. A similar example that

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<sup>323</sup> Brooks (n 223) 72-76.

<sup>324</sup> Text at n 247.

<sup>325</sup> ICTA 1988 ss 416, 417.

will be discussed in great detail in Chapter 5 is the UK settlements provisions which deem one spouse to have an interest in the other spouse's property.<sup>326</sup>

The UK capital tax regimes contain other examples of rules in which a taxpayers' marriage status will impact on his or her tax position. These rules generally are not intended to backstop anti-avoidance measures but to pursue some other objective. Often married couples are treated better for tax purposes than unmarried couples. For example, gifts between spouses are exempt for inheritance tax purposes<sup>327</sup> and any unused portion of a deceased spouse's IHT nil rate band can be utilised by the surviving spouse.<sup>328</sup> These special rules for spouses, together with the large nil rate band, ensure that the great majority of estates are not subject to inheritance tax at all. They also mean, as evidenced by the *Burden* case just discussed,<sup>329</sup> that unmarried cohabitants are subject to potentially much harsher inheritance tax treatment than married couples.

In other cases (and no doubt much to the dismay of the Conservative Party and others) married couples are in fact worse off. For example, spouses while living together may claim only one main residence exemption for capital gains tax between them;<sup>330</sup> an unmarried cohabiting couple benefits from two (possibly sizable) exemptions. As the reason for the main residence exemption is generally viewed as political,<sup>331</sup> limiting the

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<sup>326</sup> Text at n 695.

<sup>327</sup> IHTA 1984 s 18.

<sup>328</sup> IHTA 1984 s 8A-8C.

<sup>329</sup> See text beginning at n 314.

<sup>330</sup> TCGA 1992 s 222.

<sup>331</sup> *Tiley* (n 23) 664.

benefit to one property per household is hard to criticise. Whether it should be limited to one per *married* household rather than using a broader conception of household is questionable policy.

The question of whether tax rules should be grounded upon a taxpayer's relationship status (eg married) as opposed to functional characteristics independent of the form of the taxpayer's relationship has been the matter of recent debate in Canada.<sup>332</sup> As is the case in the UK, and also notwithstanding the fact that the individual is the basic tax unit for Canadian income tax purposes, personal relationships frequently enter into the determination of a taxpayer's liability and obligations. The phrase 'spouse or common law partner', and variations of it, is found in over 200 provisions of the CITA and the regulations thereto.

In 2001, the Law Commission of Canada issued a report concluding that governments need to pursue a more comprehensive and principled approach to the legal recognition and support of the full range of close personal relationships among adults. According to the Commission, this approach should be guided, first and foremost, by the values of equality (among different relationships and within relationships) and autonomy (putting in place conditions in which people can freely choose their personal relationships, free of financial or other pressures encouraging or discouraging particular forms of relationships, such as marriage).<sup>333</sup> Policies in the UK aimed at supporting the

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<sup>332</sup> Law Commission of Canada, *Beyond Conjuality: Recognizing and Supporting Close Personal Adult Relationships* (Public Works and Government Services, Ottawa 2001).

<sup>333</sup> Law Commission of Canada (n 332) chapter 2.

institution of marriage over other forms of relationship (such as those advocated by the Conservative Party) obviously fall foul of this objective. Moreover, according to the Commission, government policies should aim to protect and advance personal security, privacy and religious freedom, and they should seek to accomplish their objectives in a coherent and efficient manner.

To that end, the Commission proposed a four-step methodology for assessing existing and proposed laws that employ relationship terms. The methodology consists of four questions<sup>334</sup>:

1. Does the law pursue a legitimate policy objective? If not the law ought to be repealed or fundamentally reconsidered.
2. If the law's objectives are sound, do relationships matter? Are the relationships that are included important or relevant to the law's objectives? If not, revise the law to consider the individual and to remove the unnecessary relational reference.
3. If relationships do matter, could the law allow individuals to choose which of their own close personal relationships they want to be subject to the law? If so, revise the law to permit self-definition of relevant relationships.
4. If relationships do matter, and public policy requires that the law delineate the relevant relationships to which it applies, can the law be revised to more accurately

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<sup>334</sup> Law Commission of Canada (n 332) chapter 3.

capture the relevant range of relationships? If so, revise the law to include the appropriate mix of functional definitions and formal kinds of relationship status.

Unlike their UK counterparts, the Law Commission of Canada specifically considered the income tax law context, applying their functional methodology to selected CITA provisions such as the ability to transfer assets to a spouse or common law partner without incurring an immediate capital gains tax charge.<sup>335</sup> The Commission advocated making the income tax more individually focussed, by retaining the individual as the basic unit for the calculation of the income tax and de-emphasising conjugality specifically and taxpayers' relationships generally. Where relationships were functionally relevant to the policy objectives of the CITA, the Commission argued for a more pluralistic approach, for all persons living together in economically interdependent relationships.<sup>336</sup>

The response from tax academics to the overall report was mixed, though there was a general support for the Commission's principal conclusion that the legal treatment of close adult relationships should depend less on whether they are conjugal in nature and more on their functional relevance to the policy objectives of particular legal regimes.<sup>337</sup>

The Commission's proposals are quite far-reaching, and it is perhaps still early to tell

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<sup>335</sup> CITA s 73. This rule is the Canadian equivalent of the UK's 'no gain, no loss' rule in TCGA 1992 section 58 that provides for transfers of capital property between married persons and registered same-sex civil partners who are living together without triggering a tax charge.

<sup>336</sup> Law Commission of Canada (n 332) chapter 4, part 2, VIII.

<sup>337</sup> Lisa Philipps, 'Cracking the Conjugal Myths: What Does it Mean for the Attribution Rules?' (2002) 50 Can Tax J 1031, 1032-35 and David G Duff, 'Recognizing or Disregarding Close Personal Relationships Among Adults? The Report of the Law Commission of Canada and the Federal Income Tax' (2002) 50 Can Tax J 1021, 1022.

what impact, if any, the report will have on the Canadian legislative landscape. In the seven years that have passed since the report was issued it does not seem to have had much effect on the Canadian income tax. A full discussion of the report is beyond the scope of this thesis, but the Commission's underlying approach to how tax law should incorporate personal relationships, with less regard to form and more focus on the individual and, where necessary, the functional and qualitative characteristics of the taxpayer's relationships, is instructive and worthy of serious attention.

### *(iii) Conclusion*

Marriage as an institution remains worthy of support in the eyes of many. This is evident from the Law Commission's cohabitation study, the human rights litigation, the Church of England's call for active government support and the Conservative Party's position on tax breaks for marriage. But why should a taxpayer's personal relationship be important from a tax perspective, and, even more importantly, why should the tax system favour one form of personal relationship over another?

Respecting individual privacy and autonomy, as well as advancing neutrality, suggest the tax law system should focus more on the taxpayer and less on his or her personal relationships. This conclusion favours the individual as tax unit as well as less emphasis on marital status in rules such as the IHT spousal exemption on transfers (clearly favours marriage) and the rule restricting the main residence exemption for capital gains tax to one per married couple (clearly favours unmarried couples). To the extent that it is deemed necessary for the tax system to take into account a taxpayer's

relationship status—for administrative reasons, in order to backstop anti-avoidance rules or reduce hardship on the death of one partner—the Law Commission of Canada’s approach is worthy of serious consideration. Guided by the values of equality and autonomy, that approach focuses on the individual and, where necessary, considers the functional and qualitative characteristics of the taxpayer’s relationships. It is a more attractive and principled approach than one based on particular forms of relationship, including marriage.

#### (d) Couples Neutrality

Another argument raised in support of a spousal tax unit is that couples with equal total income pay the same tax no matter how the income is distributed between them.<sup>338</sup> Thus, a couple where one spouse earns £100,000 and the other nothing pays the same amount of income tax as a couple with both spouses earning £50,000. The 1920 and 1954 Royal Commissions supported continuing the aggregation of a wife’s income with her husband’s partly on this basis.<sup>339</sup> Prominent defenders of the US system of joint spousal returns on the basis of ‘couples neutrality’ include Surrey, Bittker<sup>340</sup> and also McIntyre and Oldman.<sup>341</sup> They argue that the principle of horizontal equity—that like taxpayers

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<sup>338</sup> Meade Report (n 13) 377, criteria 2 and 383-84.

<sup>339</sup> 1920 Royal Commission (n 169) [252-53]; 1954 Royal Commission (n 170) [119]. The Radcliffe Commission of 1954 argued against disaggregation because ‘[s]uch a method of taxation would mean that one married couple bore a greater or less burden of tax than another according to what must surely be an irrelevant distinction for this purpose, namely the proportion in which the combined income was divided between the partners’.

<sup>340</sup> Bittker (n 194).

<sup>341</sup> McIntyre and Oldman (n 194).

pay like taxes—requires that equal-income couples pay equal taxes.<sup>342</sup> Thus, although couched in terms of ‘neutrality’, it is actually equity that is the prime consideration here. Arguments for and against couples neutrality are considered next.

McIntyre and Oldman ground their support for joint taxation on the normative ideal of a comprehensive tax base (CTB).<sup>343</sup> They argue that family income should be taxed to the individuals who actually benefit from it. In a tax system based on the CTB ideal, equal-income couples should pay equal taxes, since each member of the couple will benefit more or less equally from the total available income without regard to the source distribution.<sup>344</sup> In other words, since a married couple pools its income and acts as a single economic unit, it should be taxed as a single economic unit. In the UK, Oliver and Harris take a similar stance.<sup>345</sup> Surrey, one of the prime architects of the 1948 US rules, went so far as to suggest moving to a family tax unit on the basis that the income of the family is shared by all members of the family and, further, that equal income families should be taxed equally.<sup>346</sup>

Some commentators have criticised this ‘intuitive’ assumption that married couples pool their resources, arguing either that there is not enough economic data on the extent to which married couples share income<sup>347</sup> or that the evidence that does exist

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<sup>342</sup> McIntyre and Oldman (n 194) 1579.

<sup>343</sup> McIntyre and Oldman (n 194) 1575-79.

<sup>344</sup> McIntyre and Oldman (n 194) 1590.

<sup>345</sup> Oliver and Harris (n 145) 285.

<sup>346</sup> Surrey (n 202) 1113-14.

<sup>347</sup> Carolyn Vogler, Michaela Brockmann and Richard D Wiggins, ‘Intimate Relationships and Changing Patterns of Money Management at the Beginning of the Twenty-First Century’ (2006)

points to a move towards individualisation in couple finances in recent years that may be indicative of a long-term change in norms and values.<sup>348</sup> For example, in a 2006 paper Pahl concluded that although pooling money in a joint account remains the most common form of money management, ‘fewer couples are pooling their incomes and more are keeping all or part of their incomes in individual accounts to which their partner does not have access’.<sup>349</sup> In a later article McIntyre justifies the assumption of equal pooling on the basis that married couples generally live together in the same house, eat the same kinds of food, and dress and entertain at the same social level, and that these expenses alone comprise the highest proportion of a typical household’s expenditure.<sup>350</sup> For McIntyre, whether spouses keep separate bank accounts and occasionally buy each other dinner or gifts from their personal accounts is irrelevant.

Although taxing single earner-couples the same as two-earner couples with the same income might appear equitable at first glance, an argument can be made that the two-earner couple enjoys less imputed income from self-performed services and should,

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57 British J of Sociology 455; Majorie E Kornhauser, ‘Love, Money, and the IRS: Family, Income Sharing, and the Joint Income Tax Return’ (1993) 45 Hastings L J 63; Marjorie E Kornhauser, ‘Theory versus Reality: The Partnership Model of Marriage in Family and Income Tax Law’ (1996) 69 Temple L Rev 1413.

<sup>348</sup> Jan Pahl, ‘Individualisation in Couple Finances: Who Pays for the Children?’ (2005) 4 Social Policy & Society 381, 381-87.

<sup>349</sup> Jan Pahl, ‘Family Finances, Individualisation, Spending Patterns and Access to Credit’ (Paper presented at the ESRC seminar ‘Beyond Homo Economics: Emerging Perspectives on Economic Behaviour, University of Exeter June 2006)  
<<http://209.85.229.132/search?q=cache:K13IILNSVqcJ:psynet.ex.ac.uk:8200/research/esrcseminars/prog/ESRC%2520seminar%2520at%2520Exeter%2520final%2520version.doc+pahl+family+resources+sharing&cd=8&hl=en&ct=clnk&gl=uk&client=firefox-a>> accessed 24 September 2009, 1. Pahl also speculates (at 5-6) that the growth in credit card use may be one driver for the individualisation of couple finances as credit cards are essentially an individualised medium for managing and spending money.

<sup>350</sup> McIntyre (n 228) 3.

as a result, pay less tax. Critics of couples neutrality contend that one- and two-earner couples with equal taxable incomes are generally not equal in taxpaying ability—the one-earner couple is significantly better off because of its greater imputed income from self-performed services and its lesser non-deductible work-related expenses (such as clothing and commuting).<sup>351</sup> The Meade Committee also took the position that as between two families with the same total of earned income, the family in which the income was due to the earnings of both partners could be taxed more leniently than the one-earner family in recognition of the fact that there are more expenses and more sacrifice of leisure, of home care and of do-it-yourself activity in the two-earner family.<sup>352</sup>

After examining the imputed income concept as well as proposals for indirectly taxing imputed income, McIntyre and Oldman conclude that no special adjustments in the burdens on two-job couples are justified on grounds of fairness.<sup>353</sup> The authors readily admit that the economic position of two-job couples is sometimes quite different from the position of one-job couples with the same pecuniary income, but attempt to justify their position (rather weakly) on the basis that an income tax cannot take into account all differences in economic well-being.<sup>354</sup> Moreover, they argue that an income tax which attempts to treat as income, even indirectly, the value of self-performed services is less fair, on balance, than one which does not.<sup>355</sup>

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<sup>351</sup> Zelenak (n 194) 361; Kesselman (n 190) 26-27; McCaffery (n 194) 120-26.

<sup>352</sup> Meade Report (n 13) 382.

<sup>353</sup> McIntyre and Oldman (n 194) 1609.

<sup>354</sup> McIntyre and Oldman (n 194) 1579.

<sup>355</sup> McIntyre and Oldman (n 194) 1579.

McIntyre and Oldman also object to separate taxation for all individuals on the grounds that it leads to attempts to shuffle property interests between spouses as was common in the US before joint taxation was introduced in 1948 (as discussed above).<sup>356</sup> In their view, the burden of the tax under individual taxation ‘would be a function of property shifts which have little effect on the overall economic position of the spouses’.<sup>357</sup> Similar concerns were raised by the 1920 and 1954 Royal Commissions as well as the Meade Committee.<sup>358</sup> These concerns were considered and rejected by Brice primarily on the basis that genuine transfers between married persons should be respected in the same way as genuine transfers between non-married persons.<sup>359</sup> Clearly, there will be greater opportunities for income splitting if the individual is the tax unit, rather than spouses or families. The challenge then becomes the extent to which income splitting is permitted, and what methods can be used to restrict it. This issue is a central concern of this thesis and is considered at length in Chapter 4.<sup>360</sup>

Although Bittker claimed that consolidation of family income is ‘the all but universal preference of theoreticians’,<sup>361</sup> other tax policy commentators disagree. Brice rejected the couples neutrality argument as adopted by the 1920 and 1954 Royal Commissions as a ‘logical fallacy’ for comparing the joint income of married couples in a

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<sup>356</sup> See text beginning at n 194.

<sup>357</sup> McIntyre and Oldman (n 194) 1590.

<sup>358</sup> 1920 Royal Commission (n 169) [233]; 1954 Royal Commission (n 170) [120]; Meade Report (n 13) 384.

<sup>359</sup> Brice (n 154) 357, 369, 592-93 and 627.

<sup>360</sup> See text beginning at n 525.

<sup>361</sup> Bittker (n 194) 1400. Similar claims are made in Joseph Pechman, *Federal Tax Policy, Revised Edition* (W W Norton & Company, New York 1971) 87-88.

tax system which only taxes individuals and not households.<sup>362</sup> Zelenak argues that the question is not simply whether people think equal taxation of equal-income couples is desirable, but whether it is a more important equity concern that the incompatible goal of marriage neutrality.<sup>363</sup> To Zelenak, the question comes down to whether people are more offended by equal combined-income couples paying different amounts of tax (the non-neutrality of separate returns), or by marriage penalties and marriage bonuses (the non-neutrality of joint returns).<sup>364</sup> In his view, people believe that it is more important for the tax system not to encourage or discourage marriage (especially the latter) than it is for equal-income couples to pay equal taxes.<sup>365</sup> According to Zelenak, people are more aware of marriage penalties and bonuses than they are of whether equal-income couples are paying equal taxes: marriage penalties and bonuses can be determined without reference to any other taxpayers and it is simple to calculate the effect of prospective marriage and post-marriage yearly differences.<sup>366</sup>

McCaffery is also critical of couples neutrality, but primarily on fairness of outcomes grounds. He argues that taxing equal-earning couples equally is terribly unfair because it leads to discrimination against women.<sup>367</sup> Like Zelenak, McCaffery also criticises McIntyre and Oldman for failing to include imputed income in their CTB,

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<sup>362</sup> Brice (n 154) 354 and 366.

<sup>363</sup> Zelenak (n 194) 361.

<sup>364</sup> Zelenak (n 194) 361.

<sup>365</sup> Zelenak (n 194) 361.

<sup>366</sup> Zelenak (n 194) 361.

<sup>367</sup> McCaffery (n 194) 25.

which is biased against two-earner couples.<sup>368</sup> He also challenges the assumption that married couples pool their resources as a factual matter,<sup>369</sup> though ultimately concludes actual pooling is irrelevant in any case because the end result of joint taxation is marginalisation of women.<sup>370</sup> McCaffery's arguments are considered further in the next section on 'work incentives'.

### (e) Work Incentives

As discussed in the previous Chapter,<sup>371</sup> high marginal tax rates lead to the substitution effect—as progressively more tax is levied on a taxpayer's employment earnings, so that each hour worked generates less and less additional take-home pay, the taxpayer will have a greater incentive to forgo labour for leisure or untaxed domestic work. In a joint tax unit system, the incentive for one spouse to earn can be blunted by tax considerations which depend on the economic position of the other spouse.<sup>372</sup> McCaffery<sup>373</sup> and Apps,<sup>374</sup> amongst others,<sup>375</sup> are strong critics of joint taxation because of the incentive

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<sup>368</sup> McCaffery (n 194) 123.

<sup>369</sup> McCaffery (n 194) 55, citing Kornhauser (1993) (n 347). Even if sharing is in fact unequal, this does not necessarily support individual taxation. Kaplow argues that '...one needs to determine whether individualised or family treatment is more generous in the presence of unequal sharing, whether more or less generosity is optimal in light of unequal sharing, and how the different forms of treatment may themselves affect the intrafamily allocation of resources: see Kaplow (n 25) 320-23.

<sup>370</sup> McCaffery (n 194) 55.

<sup>371</sup> Chapter 2; see text at n 86.

<sup>372</sup> Meade Report (n 13) 377, criteria 3; Hoynes (n 298) 3.

<sup>373</sup> McCaffery (n 194) 19-26.

<sup>374</sup> Patricia Apps, 'Taxation of Families: Individual Taxation Versus Income Splitting' in John G Head and Richard Krever (eds) *Tax Units and the Tax Rate Scale* (Australian Tax Research Foundation, Sydney 1996) 81.

<sup>375</sup> Zelenak (n 194) 343, 365-78; Brooks (n 223) 64-68.

effects it has on women and their participation in paid labour outside the home. Whilst tax incentives are an important consideration in this area, non-tax factors such as labour market regulation, family ideology concerning the division of labour between spouses, social security rules and the organisation of child care also have an impact on women's participation in the paid labour force.<sup>376</sup>

McCaffery argues that a joint tax unit with one rate schedule applicable to couples invariably encourages families to think in terms of a primary and secondary earner. This in turn gives rise to strong disincentives against second earners working in the paid workforce because they enter it at the high marginal tax rate of the primary earner—what McCaffery and Apps refer to as the 'secondary-earner bias'.<sup>377</sup> The Meade Committee expressed similar concerns when considering the advantages and disadvantages of an unrestricted quotient system under which a couple's earned and investment income is combined and then one-half of the total is allocated to, and taxed in the hands of, each partner.<sup>378</sup> If the husband's income more than offsets the wife's personal allowance, then under this system (and as is the case with a joint tax unit model) if the wife goes out to work she will be taxed on the whole of her earnings, potentially at a high marginal rate.

Although McCaffery acknowledges that the second earner could in some cases be the husband, he maintains (as does Apps and Brooks) that historically it is far more likely to be the wife because women earn less than men (the well-known 'gender gap') as well

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<sup>376</sup> Dingeldey (n 190) 666.

<sup>377</sup> McCaffery (n 194) 19; Apps (n 374) 84-90.

<sup>378</sup> Meade Report (n 13) 387. This point is considered again in Chapter 4; see text at n 541.

as the realities of childbirth, which will mean that a wife will need to leave the workforce temporarily and the family will be faced with the decision as to whether she should go back to work.<sup>379</sup> He concludes:<sup>380</sup>

‘However distasteful and gendered this fact might be, however we might wish for reality to be different, not seeing that women are far more likely to be the secondary earners will blind us to a very large set of problems.’

Thus, tax commentators including McCaffery, Apps and Brooks are opposed to a joint tax unit because it gives rise to secondary-earner bias, which is inherently unfair to women. In support of this position, they point to empirical evidence suggesting that the labour supply curve for women—and especially married women—is much more elastic than for men, meaning that women’s participation in the paid labour force is affected much more than men by changes in tax rates.<sup>381</sup> In fact, for this reason Apps and McCaffery argue that men should be taxed more heavily than women—and especially married women—because most men will continue to work irrespective of increases in tax

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<sup>379</sup> McCaffery (n 194) 21-22; Apps (n 374) 89-90; Brooks (n 223) 66.

<sup>380</sup> McCaffery (n 194) 21.

<sup>381</sup> McCaffery (n 194) 175-77; Apps (n 374) 89-90; Barr (n 154) 402; Kaplow (n 25) 81-82. Recent US research, however, suggests that married women’s labour supply elasticities fell by over 50% in the period from 1980 to 2000 thus becoming more like married men’s: see Francine Blau and Lawrence Kahn, ‘Changes in the Labor Supply Behavior of Married Women: 1980-2000’ (2007) 25 *J Labor Econ* 393, 395. According to Hoynes, in the UK, the overall employment rates are indeed lower for women, and especially women with children: see Hoynes (n 298) 4. In 2005-06, employment rates for women vary from 0.58 for single women with children, 0.68 for married women with children to 0.78 for single women without children and 0.83 for married women without children. There is less variation for men, ranging from 0.75 to 0.91.

rates.<sup>382</sup> More recently, Brewer, Saez and Shephard survey the economic literature and arrive at this same conclusion.<sup>383</sup>

Zelenak agrees with McCaffery that the US spousal tax unit system strongly discourages a married woman from seeking employment by stacking her income on top of her husband's, so that even her first dollar of income is taxed at a high marginal rate.<sup>384</sup> As discussed in the previous section,<sup>385</sup> Zelenak is also critical of the tax treatment of imputed income and non-deductible work-related expenses for encouraging wives not to enter or re-enter the labour force, thereby perpetuating gender role stereotypes and the economic dependence of women.<sup>386</sup> Apps takes a similar position.<sup>387</sup> In addition, McCaffery argues that outside work is more important for women than just earning money; it provides access to a circle of other workers, gives relief from the often stressful chores of housework and childrearing, and breeds economic and social independence.<sup>388</sup>

Unlike McCaffery, Zelenak is not convinced that the two-earner marriage model is more ideal than the traditional one-earner model, and instead takes the position that the tax system should be neutral. Zelenak argues that whilst a joint tax unit system pushes

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<sup>382</sup> McCaffery (n 194) 177; Apps (n 374) 89-90.

<sup>383</sup> Brewer, Saez and Shephard (n 150) 30. Kaplow does not support differential taxation because the source of the differences in labour supply elasticities between primary and secondary is not well understood and may bear on optimal tax treatment: see Kaplow (n 25) 338.

<sup>384</sup> Zelenak (n 194) 343.

<sup>385</sup> See text at n 351.

<sup>386</sup> Zelenak (n 194) 363.

<sup>387</sup> Apps (n 374) 83-84.

<sup>388</sup> McCaffery (n 194) 158.

couples towards the traditional family model and away from the two-earner model, an individual tax unit system lets each spouse begin at the bottom of the rate schedule, thus removing the work disincentive effect on married women. The advantage of mandatory individual taxation for Zelenak is that it can be persuasively defended as reflecting governmental neutrality on a divisive issue, and favouring neither traditional families nor two-earner couples.<sup>389</sup>

Finally, these work incentive effects may have broader efficiency implications as well. In an Australian study, Jones and Savage simulated the economic impacts of moving from an individual unit to a joint tax unit with income splitting. The authors concluded that the prime beneficiaries of such a move would be higher-income, one earner households, and it would lead to overall efficiency losses of 0.5% of income tax collections annually.<sup>390</sup>

In summary, whatever one's views on the debate between marriage neutrality and couples neutrality, it is difficult to argue with McCaffery, Apps and Zelenak's concerns over the secondary-earner bias inherent in a joint tax unit, and the impact it has on women. They provide strong arguments in favour of an individual tax unit.

### **3. CONCLUSION ON TAX UNIT**

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<sup>389</sup> Zelenak (n 194) 371.

<sup>390</sup> Glenn Jones and Elizabeth Savage, 'Income Splitting: Equity, Efficiency and Work Disincentives' in John G Head and Richard Krever (eds) *Tax Units and the Tax Rate Scale* (Australian Tax Research Foundation, Sydney 1996) 107, 112-20.

On balance, the arguments examined above strongly favour an individual tax unit over a joint unit. It is thus not surprising that most OECD countries have adopted the individual. Although couples neutrality and reducing the incentive to income split favour a joint unit, the individual is the better choice on privacy, autonomy, equality, definitional, marriage neutrality and work incentive grounds. The definitional issues inherent in a non-individual unit are particularly difficult from a horizontal equity, certainty, and ease of administration perspective. Neutrality amongst choice of form of personal relationships, and avoiding the secondary-earner bias are also attractive goals. On the other hand, when examined more closely, the reasoning behind couples neutrality is suspect at best and if any compromise has to be made amongst competing objectives (as it most certainly must), progressivity and marriage neutrality are more desirable aims.

Moving to a joint tax unit in the UK in order to restrict income splitting (and especially income-splitting arrangements involving family businesses), as the CIOT suggested considering, is crushing a nut with a sledge hammer. Many millions of taxpayers would be affected by such a move designed to address the actions of a small minority. The disadvantages strongly outweigh the advantages. It is much more desirable to address the relatively narrow issue of income splitting in family businesses by more targeted means.

### **C. A MIDDLE GROUND – SHARED OR TRANSFERABLE ALLOWANCES**

An alternative to adopting a joint tax unit is to retain the individual unit, but to allow spouses to transfer unused income tax personal allowances between them. For example,

in the UK, each taxpayer's personal tax-free allowance for income tax purposes is £6,035 (2008-09);<sup>391</sup> a taxpayer with an income of £5,000 has £1,035 of unused allowance that, under the present rules, is wasted. This middle-ground option gives some recognition of the couple as an economic unit whilst retaining the individual as the basic unit. It also reflects the underlying policy of the personal allowance that each taxpayer is entitled to earn a basic amount free of tax to provide a minimal standard of living.

Unlike the approach taken in the income tax regime, under the UK's system of capital taxation, spouses and civil partners indeed are permitted to share their tax-free allowances. Although the annual allowance for CGT purposes (a generous £9,600 for 2008-09<sup>392</sup>) belongs to each individual and are not explicitly transferable, spouses and civil partners are able to transfer capital property between them on a no gain, no loss basis,<sup>393</sup> and thus indirectly can take advantage of both spouses' allowance simply by shuffling assets between them prior to sale. Similarly, transfers of value between spouses generally are IHT exempt,<sup>394</sup> and, from 2008, if one spouse dies and does not fully utilise his or her nil rate band (£312,000 in 2008-09),<sup>395</sup> the unused portion is available to be used by the surviving spouse on his or her death.<sup>396</sup>

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<sup>391</sup> ITA 2007 s 35. Taxpayers 65 and older have a larger allowance of £9,080 (£9,180 if aged 75 or over), but the additional allowance over and above the usual personal allowance is reduced by one-half of the amount by which the taxpayer's adjusted net income exceeds £20,100: ITA 2007 ss 36-37.

<sup>392</sup> TCGA 1992 s 3(2).

<sup>393</sup> TCGA 1992 s 58.

<sup>394</sup> IHTA 1984 s 18.

<sup>395</sup> IHTA 1984 s 7 and Sch 1.

<sup>396</sup> IHTA 1984 ss 8A-8C.

Kerridge has argued for transferable allowances, but only where one spouse stays home to look after young children and then perhaps only against earned income not investment income.<sup>397</sup> At various times political parties in the UK have called for income tax allowances to be transferable as a means of supporting the institution of marriage through the tax system as discussed earlier.<sup>398</sup> Echoing a proposal in (amongst other places) the 1980 Green Paper,<sup>399</sup> the Tax Reform Commission (2006) established by the Conservative Party and chaired by Lord Forsyth called for a transferable personal allowance for couples (married and civil partners) with young children.<sup>400</sup> In the Commission's view, financial disadvantages suffered by parents, usually women, who look after children while their partners are out at work, represent a major unfairness in the tax system, and this unfairness can be addressed by giving parents an option to transfer their personal allowance to their partner while they have young children.<sup>401</sup> Relief would be available at only the basic rate.

More recently, the Conservative Party Leader David Cameron and Shadow Chancellor George Osborne confirmed their party's pledge to support the institution of marriage with tax benefits.<sup>402</sup> Although the details are still to be worked out, the media has speculated that the benefits would most likely take the form of a revival of the

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<sup>397</sup> Kerridge (n 181) 81.

<sup>398</sup> Text at n 280.

<sup>399</sup> HMSO, 'The Taxation of Husband and Wife' (n 171) 67-73.

<sup>400</sup> Tax Reform Commission, *Tax Matters: Reforming the Tax System* (Conservative Party, London 2006) 61.

<sup>401</sup> Conservative Party Tax Reform Commission (n 400) 61.

<sup>402</sup> Winnett (n 280).

married couple's allowance.<sup>403</sup> The IFS considered the Forsyth Commission's proposal in its 2007 Green Budget, and concluded that a transferable personal allowance for families with a child under 6 would benefit the majority of one-earner couples with a young child, regardless of income, but would act to discourage such families from having both adults in work.<sup>404</sup>

The same arguments for and against a joint spousal tax unit apply to transferable allowances, albeit to a lesser extent as the amounts involved are limited to the unused portion of the £6,035 annual allowance. Most importantly, and as already seen, this includes the secondary-earner bias, but privacy, autonomy and definitional concerns, as well as marriage neutrality also weigh against allowing transferable personal allowances. Moreover, the argument that the personal allowance is meant to provide a basic standard of living is not relevant in many situations. Allowing the stay-at-home wife of a high-paid investment banker or corporate lawyer to transfer her unused allowance to her husband, thus shielding from tax a portion of his income otherwise taxable at the highest marginal rate, is difficult to justify on equity grounds. If allowances were to be transferable, at the very least this suggests limiting the tax benefit to the equivalent of the basic rate. This is the practice in Canada, where various non-refundable credits can be claimed against federal tax owing, with the amount credited calculated by reference to the lowest federal marginal tax rate.<sup>405</sup> As a result, the credit is worth the same to high- and

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<sup>403</sup> Winnett (n 280) and see text at n 176.

<sup>404</sup> M Brewer, 'Supporting Couples with Children through the Tax system' in R Chote and others (eds), *The IFS Green Budget, January 2007* (The Institute for Fiscal Studies, London 2007) 229-30.

<sup>405</sup> CITA s 118(1). For 2009, the basic personal credit is  $\$10,320 \times 15\% = \$1,548$ .

low-rate taxpayers. A taxpayer with insufficient tax owing to fully utilise certain types of tax credits (eg pension, tuition and education, disability and age but importantly not other credits including the basic personal amount) can elect to transfer the unused portion to his or her spouse.<sup>406</sup>

Furthermore, the fact that allowances are transferable for CGT and IHT purposes does not necessarily mean they should also be for income tax. First, taxes on the movement of capital raise different policy issues and have different policy objectives than income taxes. For example, if IHT at 40% was payable on an estate comprised mainly of the family home this could mean that the deceased's surviving spouse would have to sell his or her home to pay the tax. Such a result does not appear socially desirable and is probably a nonstarter politically, though apparently not important enough to warrant extending the spousal exemption to cover other long-term relationships such as that of the sisters in *Burden and Burden* discussed above.<sup>407</sup> It is also a much harsher result than merely denying one spouse the benefit of the other spouses' comparatively small income tax personal allowance.

Another argument supporting both the CGT and IHT spousal exemptions is that it allows spouses to make decisions as to the ownership of their property, and make gifts to one another, without involving the taxman in their 'bedroom transactions'—at great cost, inconvenience and intrusion.<sup>408</sup> It should also be noted that the comparatively high

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<sup>406</sup> CITA s 118.8.

<sup>407</sup> Text at n 314.

<sup>408</sup> Bittker (n 194) 1441.

allowances coupled with tax free inter-spousal transfers and effectively transferable allowances removes a great many taxpayers from the capital tax net entirely. As a result, the number of taxpayers subject to IHT and CGT is a small fraction of the number subject to income tax, thus easing the administration and cost of collection of CGT and IHT immensely. For 2008-09, HMRC estimates there will be 31 million taxpayers subject to income tax, but only 350,000 subject to CGT and less than 30,000 for IHT.<sup>409</sup> The small number of capital taxpayers reflects the comparatively narrow focus of those taxes on the wealthy and on high value transfers of capital. Transferable allowances for income tax purposes, on the other hand, would not significantly reduce the income tax administrative burden and could well increase it. Furthermore, CGT and IHT transferable allowances do not give rise to the secondary-earner bias, whilst a transferable allowance for income tax purposes does. Finally, the capital taxes are less progressive than the income tax as well, particularly since the introduction of the 18% flat CGT rate in 2008,<sup>410</sup> which reduces (but does not eliminate) the tax benefits to be had from ‘capital splitting’ within the family.

#### **D. CONCLUSION**

The above analysis supports retaining the individual as the tax unit in the UK income (and capital gains) system, and rejecting calls for transferable income tax personal allowances. In cases where it is desirable to take into accounts a taxpayer’s personal

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<sup>409</sup> HM Revenue & Customs, ‘Tax Receipts and Taxpayers’ Table 1.4  
<[http://www.hmrc.gov.uk/stats/tax\\_receipts/menu.htm](http://www.hmrc.gov.uk/stats/tax_receipts/menu.htm)> accessed 27 August 2008.

<sup>410</sup> TCGA 1992 s 4.

relationships—eg for anti-avoidance legislation—reliance on specific forms of relationship such as marriage should be eschewed in favour of a more comprehensive and principled approach to the legal recognition and support of the full range of close personal relationships among adults. As the Law Commission of Canada recommended, this approach should be guided, first and foremost, by the values of equality (among different relationships and within relationships) and autonomy (putting in place conditions in which people can freely choose their personal relationships).

Adopting the individual as tax unit means that families will have an incentive to split income to minimise their combined income tax burden. If left unchecked, income splitting undermines the individual tax unit as some taxpayers are able to self-select a joint unit despite the fact that for privacy, autonomy, definitional and work incentive reasons the individual is the proper choice. This does not necessarily mean, however, that all forms of income splitting should be restricted. These issues are considered in the next Chapter.

# CHAPTER FOUR: INCOME ATTRIBUTION AND INCOME SPLITTING

## A. INTRODUCTION

Once it has been determined that the individual is the proper choice for income tax unit, the next logical issue the tax system must address is on what basis income is to be attributed to each individual. This is an important question for an enquiry into income splitting—it makes little sense to discuss taxpayers shifting income to other taxpayers until one has first identified what income properly can be said to belong to which taxpayer. As will be seen, many of the considerations that arise in choice of tax unit are also relevant when considering possible income attribution approaches, including definitional issues, relationship neutrality, work incentives and privacy/autonomy concerns.

Part B begins by discussing two main conceptual bases for attributing income to taxpayers—the *control* and *benefit* models. Part C examines the applicability of attribution rules to different forms of income, namely earned income (referred to by economists and in this thesis as ‘labour income’), unearned (referred to by economists and in this thesis as ‘capital income’) and mixed income. A number of difficult questions arise in this area. Do labour and capital income warrant different treatment from an income-attribution perspective? Should capital income be taxed in the hands of the taxpayer who owns the underlying asset, or does the ease in which income-producing

assets can be transferred to (lower-taxed) family members mean that a different approach is warranted? How should business profits representing a mixed return from labour and capital be taxed and attributed? These issues raise important equity and neutrality considerations, but certainty and administrative ease are also relevant. A key concern is whether wealthy taxpayers should be allowed to shift income to lower-taxed family members simply by transferring the assets generating the income (eg rental property, quoted shares) to those family members, especially when less well-off taxpayers with earnings solely from employment cannot so easily shift their income. The approaches adopted by the UK and other tax authorities, especially Canada, to some of these issues are considered. Part C concludes with a consideration of how profits representing the joint effort of two or more related persons should be attributed to each individual for tax purposes.

Part D addresses the implications of the discussion in Part B and C for income splitting generally. Once the most appropriate attribution rules have been established, attempts by taxpayers to circumvent these rules in an attempt to save tax are problematic. Part E concludes.

## **B. GENERAL APPROACHES TO INCOME ATTRIBUTION**

### **1. BACKGROUND**

The previous Chapter concluded that the best choice for taxable unit in an income tax system is the individual. Once that choice has been made, the next issue that needs to be addressed is to determine, on a principled basis, how income is to be attributed to each

individual taxpayer. Once income has been so-identified with a taxpayer, it is then possible to consider how to deal with attempts by taxpayers to shift that income to another in order to minimise tax.

If taxpayers are able to move income to other family members such as a spouse in order to save tax then they are effectively self-selecting a joint tax unit. This raises horizontal equity concerns vis-à-vis other, similarly-situated taxpayers who are unable or unwilling to shift income. It also undermines the individual basis of taxation, which the previous Chapter concluded on policy grounds (ie marriage neutrality, work incentives, definitional reasons, privacy and autonomy) remained the most appropriate choice for tax unit. The UK Government raised this particular concern in the 2007 Pre-Budget Report when announcing its intention to legislate to combat income-splitting arrangements involving family businesses:<sup>411</sup>

‘[T]he Government believes it is unfair for one person to arrange their affairs so that their income is diverted to a second person, subject to a lower tax rate, to obtain a tax advantage (income shifting). The vast majority of individuals cannot shift their income and income shifting runs counter to the principle of independent taxation.’

How then can income be said to belong to a particular taxpayer and not to another? As a preliminary point it should be noted that tax systems generally do not seek to tax people on what they *could* earn, but rather tax them on the income they *do* earn. Although equating ability to pay with ability to earn has some proponents, the practicalities of

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<sup>411</sup> HM Treasury, ‘2007 Pre-Budget Report’ Press Notice 02 (9 October 2007) <[http://www.hm-treasury.gov.uk/pbr\\_csr07\\_press02.htm](http://www.hm-treasury.gov.uk/pbr_csr07_press02.htm)> accessed 15 April 2009.

measuring what a taxpayer might have earned make such an approach unrealistic.<sup>412</sup> Moreover, taxpayers faced with a range of available options ordinarily are not obligated to choose the option that gives rise to the highest tax liability.<sup>413</sup>

Consider the following example: a husband owns a rental property that generates an annual income of £6,000. He is in a high marginal tax bracket, whilst his wife has no income. He decides to give the property to his wife, outright and unconditionally, with the result that she is now the owner of the property. She begins receiving the rental income and pays no tax because the income is sheltered by her personal allowance. The husband and wife have saved (and the Treasury has lost) £2,400 in taxes in comparison to the pre-gift situation. Does this constitute income-shifting or is the husband merely giving away the opportunity to earn income to his wife—now the legal owner of the property—and the income derived from it? The answer is not clear, and tax commentators have taken different approaches to the question of how best to tax this situation.<sup>414</sup>

## 2. BENEFIT AND CONTROL

The most prominent theoretical approaches for attributing income to taxpayers are the *benefit* and *control* models, both of which made a brief appearance in Chapter 3 in the section on ‘couples neutrality’.<sup>415</sup> The issue of how to attribute income is closely related

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<sup>412</sup> Tiley (n 23) 171-72.

<sup>413</sup> *IRC v Duke of Westminster* [1936] AC 1.

<sup>414</sup> See discussion on ‘Attribution of Capital Income’ at n 528.

<sup>415</sup> Chapter 3, text at n 338.

to the choice of tax unit—those favouring the benefit model generally argue for a joint or family tax unit whilst those advocating the control model favour the individual unit. Although choice of tax unit and rules for allocating income to each tax unit are related concepts, they are in fact conceptually distinct. One could decide that the individual is the proper choice for tax unit (as argued in Chapter 3) and yet still take the position that certain forms (or sources) of income should be split or allocated between married units irrespective of actual ownership or control of the income-producing asset (eg 50% to each spouse). The tax consequences in the hands of each spouse would then depend on the totality of his and her particular situation, ie the amount of income each has from other sources, available losses, their marginal tax rate, and so forth.

The benefit and control approaches to attributing income to a tax unit are considered in more detail next.

#### (a) Benefit

As mentioned in the preceding Chapter,<sup>416</sup> McIntyre and Oldman are prominent proponents of the benefit model, which holds that income should be attributed to the person who uses or benefits from the income.<sup>417</sup> Advocates of the benefit approach to income attribution find support for their position in the Haig-Simons formulation of income as the algebraic sum of (1) the market value of rights exercised in consumption

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<sup>416</sup> Chapter 3, text at n 224. McIntyre and Oldman describe it as the ‘benefit rule’. This is to be distinguished from the benefit principle described in Chapter 2 pursuant to which tax imposed by the state should reflect the benefits the taxpayer receives from the state: see text at n 33.

<sup>417</sup> McIntyre and Oldman (n 194). In later writing McIntyre uses the term ‘enjoyment’ rather than ‘benefit’: McIntyre (n 228) 1.

and (2) the change in the value of the store of property rights between the beginning and end of the period in question.<sup>418</sup> Because income is defined in terms of its *uses* (ie consumption or savings) rather than *sources*,<sup>419</sup> the attribution rule most in harmony with the Haig-Simons definition of income is that each family member should be taxed on what he or she actually consumes or accumulates, regardless of source.<sup>420</sup> If, on the other hand, family income is taxed on the basis of sources, then only the income earner is taxed, despite the fact that his personal use of that income might be minimal.<sup>421</sup> This definitional argument is weakened somewhat by the fact that the Haig-Simons definition itself focuses on identifying income and says nothing about who is to be taxed on the income so identified.<sup>422</sup>

In addition to this definitional point, supporters of the benefit model argue that it is more *equitable* to tax income in the hands of those who actually consume or accumulate it (ie benefit from it) regardless of source.<sup>423</sup> As noted in Chapter 3,<sup>424</sup> underlying this argument is a basic assumption that married couples and families pool their income and thus it is unfair and unrealistic to take the position that income earned by one family member ‘belongs’ to that family member alone. As Oliver and Harris

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<sup>418</sup> Robert Haig, ‘The Concept of Income: Economic and Legal Aspects’ in *The Federal Income Tax* (Columbia University Press, New York 1921) 1 and Simons (n 45) 49. Haig and Simons drew on the earlier work of the German economist Goerge van Schanz, eg ‘Der Einkommensbegriff und die Einkommensteuergesetze’ (1896) 13 *Finanzarchiv* 1 and for that reason the Haig-Simons definition of income is also known as the Schanz-Haig-Simons definition.

<sup>419</sup> McIntyre and Oldman (n 194) 1575-6.

<sup>420</sup> McIntyre and Oldman (n 194) 1576.

<sup>421</sup> McIntyre and Oldman (n 194) 1577.

<sup>422</sup> Bittker (n 194) 1421.

<sup>423</sup> McIntyre and Oldman (n 194) 1576-77.

<sup>424</sup> Chapter 3, text at n 224.

argue: '[t]he problem is that families share resources. While it may be clear what a family's "own income" is (assuming one can identify what is and what is not a family), it cannot be clear what is and what is not a particular family member's "own income"'.<sup>425</sup> Though there is little in the way of empirical evidence supporting the assumption that families pool resources,<sup>426</sup> the basic premise that within the family unit members share roughly the same standard of living is intuitively attractive.

Another argument in favour of the benefit approach in the context of a married couple is that marriage creates obligations of support and restrictions on the rights of spouses to transfer property during their lifetimes and at death.<sup>427</sup> Consequently, it is no longer meaningful or relevant to call one spouse's income 'his' or 'hers' in the same way one would a single person whose income is unfettered by marital obligations. Critics argue that this 'marriage partnership' reflects a voluntary choice and deciding to enter into marriage (with the consequent financial and legal rights and obligations) should no more affect one's tax position than the decision to take a holiday.<sup>428</sup> Whilst this criticism has some merit, it is also undeniably the case that entering into other forms of contracts such as business agreements could equally be described as 'voluntary' and yet tax results will unquestionably flow from the contractual outcomes.

## (b) Control

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<sup>425</sup> Oliver and Harris (n 145) 285.

<sup>426</sup> Chapter 3, text at n 347, citing Kornhauser and Pahl.

<sup>427</sup> Bittker (n 194) 1420.

<sup>428</sup> Bittker (n 194) 1420.

An alternative approach to allocating income is the *control* model. This model focuses on who has property rights over, and legal entitlement to, income, as opposed to considering who ultimately enjoys the benefit of it. Proponents of the control model argue that taxation based on property rights and legal control is simple and accords with the traditional conception of income taxation as well as how actual income tax systems work.<sup>429</sup> For example, in the case of earned income such as employment earnings, Zelenak argues that earners should be taxed on their earnings—regardless of whether and how they decided to share the fruits of their labour—because earners always have a closer connection to their earnings than anyone else can possibly have, and can alone decide whether and how much to work.<sup>430</sup> Similarly, in the case of unearned income, owners of wealth can always determine how to employ that wealth.<sup>431</sup>

Furthermore, even if one accepts that consumption is in fact shared within the family—as proponents of the benefit approach such as McIntyre and Oldman as well as Oliver and Harris argue—there is strong evidence that *control* over income is not; it is the income-earner that retains control over the general standard of living of the family and decides how the income is applied (which may lead to shared consumption).<sup>432</sup> Thus, even if earners or owners cede some control over the consumption of their income by marrying, they still have control over the source of the income as well as control over

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<sup>429</sup> Zelenak (n 194) 357; Kesselman (n 190) 8; Brooks (n 223) 47.

<sup>430</sup> Zelenak (n 194) 357; Brooks (n 223) 62-63. This position also finds support in the US Supreme Court decision in *Lucas v Earl*; see text at n 197.

<sup>431</sup> Zelenak (n 194) 357; Brooks (n 223) 69-70.

<sup>432</sup> Zelenak (n 194) 355.

whether to remain married.<sup>433</sup> This line of argument suggests that the control model is the most appropriate basis for income attribution. Finally, it is arguable that proponents of the benefit approach to income taxation are in fact really supporting a consumption tax.<sup>434</sup> Whether control or consumption is a better measure of ability to pay is an interesting question, and one that has been much debated, but it is indeed a very different question from how income should be attributed for purposes of an income tax.<sup>435</sup>

### **3. CONCLUSION**

Control and benefit represent the principal models of income attribution, but these two approaches have their flaws and their critics. As Kesselman notes, both models are difficult concepts to translate into observable criteria for real-world application.<sup>436</sup> He concludes while both benefit and control approaches are useful, neither approach is decisive because it cannot be assumed that a couple's joint resources are fully shared or that the spouse who earns the income / has legal entitlement to it exerts full control without the influence of the other spouse.<sup>437</sup>

The next Part considers the application of the control and benefit models in relation to the attribution of income from various types or sources.

### **C. ATTRIBUTION BY TYPE OF INCOME**

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<sup>433</sup> Zelenak (n 194) 357.

<sup>434</sup> Zelenak (n 194) 357; Brooks (n 223) 69-70.

<sup>435</sup> The consumption versus income tax debate is discussed briefly below; see text at n 472.

<sup>436</sup> Kesselman (n 190) 8.

<sup>437</sup> Kesselman (n 190) 8.

This section examines the attribution of specific types of income—labour (or earned), capital (or unearned), and mixed labour and capital. As a preliminary point, tax systems traditionally do tax different types of income differently, which might suggest that different attribution rules should be adopted for different types of income, whether control, benefit or something else. The different tax treatment of different forms of income is discussed first, followed by a consideration of attribution rules by type of income. As the discussion that follows is influenced heavily by economic analysis, the term ‘labour income’ is used rather than earned income, and ‘capital income’ rather than unearned or investment income.

## **1. TAX TREATMENT OF DIFFERENT FORMS OF INCOME**

### **(a) Taxation of Labour versus Capital Income**

Should labour and capital income be treated differently for tax purposes generally? As briefly mentioned in Chapter 2, in the UK labour income is clearly taxed more heavily than capital income. In 2008-09 the top income tax plus employee NIC rate on employment earnings is 41%, but the top tax rate on capital gains is only 18%.<sup>438</sup> Furthermore, interest, dividends and capital gains are not subject to NICs. The top income tax rate on interest is 40%<sup>439</sup> and on dividends is 32.5% (rising to 42.5% from April 2010).<sup>440</sup> The difference between the tax on these sources and labour is even more

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<sup>438</sup> Chapter 2, text at n 91.

<sup>439</sup> The ‘higher rate’: ITA 2007 s 6(1)(c).

<sup>440</sup> The ‘dividend upper rate’: ITA 2007 s 8(2) and HM Treasury, ‘Budget 2009’ (n 7) [5.88].

pronounced for basic-rate taxpayers.<sup>441</sup> Labour income is taxed at a combined income tax and employee-NIC rate of about 33% whilst interest is taxed at 20%<sup>442</sup> and dividends at 10%.<sup>443</sup> This discrepancy is set to widen from April 2010 when the new top income tax rate of 50% on income over £150,000 takes effect, resulting in a combined income tax plus employee NIC of 51.5%.<sup>444</sup> The effect of this disparate treatment will inevitably be to encourage taxpayers to attempt to convert income into capital, eg through share option schemes.<sup>445</sup> Some commentators have argued that income from capital should be taxed at least as heavily as labour income if not more heavily because it is wealthy people who have capital income such as interest and dividends.<sup>446</sup> Others (particularly economists) argue capital income should be taxed more lightly than labour income or not taxed at all.<sup>447</sup> These arguments are considered in more detail next.

As a preliminary matter it is important to note that labour and capital income are on completely different scales when it comes to the amount of tax revenue generated by

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<sup>441</sup> Taxpayers in the 20% tax bracket, applicable on taxable income up to £34,800 for 2008-09: ITA 2007 ss 6(1)(b) and 10(5).

<sup>442</sup> From 2008-09, there is a 10 per cent starting rate for savings income only, with a limit of £2,320: ITA 2007 ss 7 and 12. If an individual's taxable non-savings income is above this limit then the 10 per cent starting rate for savings will not apply.

<sup>443</sup> The tax of 10% payable on dividends is cancelled out by a non-refundable credit for lower and basic rate tax payers and non-taxpayers: ITA 2007 ss 8(1).

<sup>444</sup> HM Treasury, '2009 Budget' (n 7) [5.88]. Income falling in the narrow band between £100,000 and approximately £113,000 will be subject to an even higher combined income tax and employee NIC rate of 61.5%.

<sup>445</sup> Vanessa Houlder, 'Focus on Capital Gains Set to Sharpen' *Financial Times* (London 24 April 2009) <[http://www.ft.com/cms/s/0/cbe90560-3066-11de-88e3-00144feabdc0,dwp\\_uuid=ae2324c8-28fc-11de-bc5e-00144feabdc0.html](http://www.ft.com/cms/s/0/cbe90560-3066-11de-88e3-00144feabdc0,dwp_uuid=ae2324c8-28fc-11de-bc5e-00144feabdc0.html)> accessed 27 April 2009. See also Alistair Dawber, 'Bankers Battle to Avoid 50p Tax on Bonuses' *The Independent* (London 6 July 2009) <<http://www.independent.co.uk/news/business/news/bankers-battle-to-avoid-50p-tax-on-bonuses-1732747.html>> accessed 6 July 2009.

<sup>446</sup> This is discussed in detail below at n 461.

<sup>447</sup> This is discussed in detail below at n 525.

these activities. By far the largest source of UK income tax receipts comes from taxing employment income. Of the estimated £147 billion in income tax receipts for 2007-08, £127 billion (or 86 per cent) comes from PAYE alone.<sup>448</sup> A further £100 billion is raised from NICs.<sup>449</sup> Tax receipts on capital income (eg rent, interest and dividends on quoted shares) are much lower; capital gains tax is expected to raise a mere £5.3 billion in 2007-08.<sup>450</sup>

The Carter Commission famously championed the Haig-Simons comprehensive income tax described above,<sup>451</sup> concluding that income should be taxed the same regardless of source ('a buck is a buck').<sup>452</sup> Under the Commission's approach, capital income (particularly capital gains) and labour income was subject to the same tax treatment. This conclusion was justified primarily on horizontal equity grounds:<sup>453</sup>

'A dollar gained through the sale of a share, bond or piece of real property bestows exactly the same economic power as a dollar gained through employment or operating a business. The equity principles we hold dictate that both should be taxed in exactly the same way. To tax the gain on the disposal of property more lightly than other kinds of gains or not at all would be grossly unfair.'

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<sup>448</sup> HM Revenue & Customs, 'Income Tax Receipts by Type' Table 2-8 (September 2008) <[http://www.hmrc.gov.uk/stats/t\\_receipt/table2-8.pdf](http://www.hmrc.gov.uk/stats/t_receipt/table2-8.pdf) > accessed 22 April 2009.

<sup>449</sup> HM Treasury, 'Budget 2009' (n 7) Table C6.

<sup>450</sup> HM Treasury, 'Budget 2009' (n 7) Table C6.

<sup>451</sup> Text at n 418.

<sup>452</sup> Carter Commission (n 13) Vol 1, 9-10 ('If a man obtains increased command over goods and services for his personal satisfaction we do not believe it matters, from the point of view of taxation, whether he earned it through working, gained it through operating a business, received it because he held property, made it by selling property, or was given it by a relative').

<sup>453</sup> Carter Commission (n 13) Vol 1, 14.

Crawford and Freedman similarly argue that equity demands capital and labour should be taxed at the same rate.<sup>454</sup> Nevertheless, different treatment for different types or sources of income has been the norm in most income tax systems, including the UK. For example, from the mid 1970s to the mid 1980s an investment income surcharge of 15% was levied in the UK, resulting in a top marginal income tax rate on investment income of 98% at its peak.<sup>455</sup> Although the investment income surcharge was repealed, other differences remain. The most prominent example is that NICs are levied on earnings from employment and (to a lesser extent) self-employment, but not capital income such as interest, dividends or capital gains.<sup>456</sup> Another example is the markedly different treatment accorded under UK tax law (as in many other jurisdictions) for capital gains as compared to income.<sup>457</sup> Capital gains generally are taxed on a realisation basis rather than an accrual basis and at various times in the UK have been given either special tax allowances (eg indexation allowance and taper relief<sup>458</sup>) or, as is currently the case, been subject to lower rates of tax compared to labour income. Finally, many forms of savings benefit from preferential tax treatment, such as pensions, Individual Savings Accounts,<sup>459</sup> and the principal residence.<sup>460</sup>

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<sup>454</sup> Crawford and Freedman (n 94) [IV.3.1].

<sup>455</sup> Adam, Browne and Heady (n 90) 8.

<sup>456</sup> Chapter 2, text at n 439.

<sup>457</sup> For example, in Canada only a specified portion (at times 75%, 67% and currently 50%) of a taxpayer's capital gain is included in taxable income and subject to income tax at the usual rates: see Canada Revenue Agency, 'Capital Gains – 2008' <<http://www.cra-arc.gc.ca/E/pub/tg/t4037/t4037-e.html>> accessed 15 April 2009.

<sup>458</sup> See text beginning at n 467 for a brief explanation of indexation allowance and taper relief.

<sup>459</sup> Adam, Browne and Heady (n 90) 19.

<sup>460</sup> The gains from which are exempt from capital gains tax: TCGA 1992 s 222.

Whilst horizontal equity may require taxing income the same regardless of source, taxing capital income at higher rates than labour income can also be justified on vertical equity (redistributive) grounds on the basis that it is the well-off who earn capital income such as interest, dividends and capital gains whilst the less well-off have only income from their own labour.<sup>461</sup> Thus, it is argued, the vertical equity of the tax system can be enhanced by taxing capital income more heavily than labour income. The investment income surcharge described above is a good illustration of this approach. Moreover, as noted in Chapter 2, commentators including Redston and Bittker claim that it is unfair that families with investment income can reduce their total income tax burden by entering into income-splitting arrangements whilst families with earned income cannot.<sup>462</sup> Whilst this argument is sometimes framed on horizontal equity grounds it is better described as a criticism on vertical equity grounds as the families cannot be said to be similarly-situated.

Despite the neutrality and equity-based arguments that support taxing capital income and labour income equally (or, for equity reasons, taxing capital more heavily), other tax policy commentators argue that capital income should be taxed more lightly than labour income or not taxed at all. This position is sometimes justified on the grounds that taxing capital income is double-taxation, eg taxing people on income and then taxing them again on savings.<sup>463</sup>

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<sup>461</sup> Freedman and Schuz (n 80) 205; Crawford and Freedman (n 94) at footnote 68.

<sup>462</sup> Chapter 2, text at n 80. See also the UK Government's statement to that effect in the 2007 Pre-Budget Report quoted above at n 411.

<sup>463</sup> JS Mill, *Principles of Political Economy* (J W Parker and Sons, London 1857) Book V, Ch 1 §4.

In their paper for the Mirrlees Review, Griffin, Hines and Sørensen advanced a number of other (primarily pragmatic) arguments in favour of lighter taxation of capital income.<sup>464</sup> First, they cite the high and growing international mobility of portfolio capital combined with the practical difficulties of enforcing taxes on capital income from foreign sources.<sup>465</sup> A second justification for a low capital income tax rate is that tax is typically levied on the entire return to capital despite the fact the some portion of the nominal return reflects an inflation premium.<sup>466</sup> On this point, the UK tax system has adopted various means of taking into account the fact that nominal gains on capital assets reflect in part inflationary gains. Under indexation allowance (now only available for companies) the cost base of a disposed asset is increased by a factor reflecting the rise in the retail price index over the holding period.<sup>467</sup> Indexation relief for individuals was frozen in April 1998 when ‘taper relief’ was introduced, under which a specified portion of the nominal gain was exempted from capital gains tax according to the length of time the disposed asset had been held and whether the asset was a business or non-business asset.<sup>468</sup> As the taxable portion of the gain decreased over the holding period, taper relief arguably reflected a concession for the effect of inflation, albeit in a much less systematic

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<sup>464</sup> Griffith, Hines and Sørensen (n 83) 74-75.

<sup>465</sup> Griffith, Hines and Sørensen (n 83) 74.

<sup>466</sup> Griffith, Hines and Sørensen (n 83) 74.

<sup>467</sup> TCGA 1992 ss 53-57.

<sup>468</sup> Formerly TCGA 1992 s 2A and Sch A1. Taper relief was more generous for business assets than non-business assets. For business assets, 75% of the gain would not be taxable once the asset had been held for a mere two years. For non-business assets, the maximum relief was only 60% of the gain and that was required a holding period of at least ten years. From April 2008, indexation and taper relief for individuals were withdrawn and replaced with the low 18% flat capital gains tax rate.

and precise way than indexation.<sup>469</sup> Finally, Griffin, Hines and Sørensen argue that some types of income from capital are difficult to tax for administrative or political reasons.<sup>470</sup> For example, a lower rate of tax on capital income reduces the inter-asset distortions to the saving pattern that arises vis-à-vis non-taxable capital income (eg gains on a principal residence) and may also make it easier to broaden the tax base.<sup>471</sup>

A related argument is that capital income should not be taxed at all because taxing capital income distorts an individual's choice between immediate and future consumption. This argument is central to the famous debate between those who favour a consumption tax (eg Professor Andrews and Nicholas Kaldor) that exempts accumulations and those who favour income taxes (eg Professor Warren) that tax the return to savings.<sup>472</sup> The conclusion that capital income should not be taxed has been supported by consumption tax advocates on optimal tax theory grounds.<sup>473</sup>

The conventional economic wisdom favouring a pure consumption tax that does not tax return to savings has been questioned recently by Banks and Diamond.<sup>474</sup>

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<sup>469</sup> The low 18% flat rate of capital gains tax can also be justified as reflecting, again in a 'rough and ready' way, the inflationary component of capital gains viewed in totality.

<sup>470</sup> Griffith, Hines and Sørensen (n 83) 74.

<sup>471</sup> Griffith, Hines and Sørensen (n 83) 74.

<sup>472</sup> William D Andrews, 'A Consumption-type or Cash Flow Personal Income Tax' (1974) 87 *Harvard L Rev* 1113; Alvin C Warren Jr, 'Fairness and a Consumption-type or Cash Flow Personal Income Tax' (1975) 88 *Harvard L Rev* 931; William D Andrews, 'Fairness and the Personal Income Tax: A Reply to Professor Warren' (1975) 88 *Harvard L Rev* 947; Nicholas Kaldor, *An Expenditure Tax* (Allen and Unwin, London 1955).

<sup>473</sup> See eg Joseph Bankman and David Weisbach, 'The Superiority of an Ideal Consumption Tax over an Ideal Income Tax' (2006) 58 *Stanford L Rev* 1413; Griffith, Hines and Sørensen (n 83) 78-79.

<sup>474</sup> Banks and Diamond (n 34) 2 ('We argue that a widely recognized result of the optimal tax literature—that capital income should not be taxed...—arises from considerations of individual behaviour and the nature of economic environments that are too restrictive when viewed in the

Controversially, the authors conclude that there should be some role for including capital income as a component of the tax base, but stop short of recommending a tax rate or even a range of rates.<sup>475</sup> According to Banks and Diamond, the tax base should not simply aggregate capital and labour income, but instead the marginal tax rates on capital and labour income should be related in some way to each other.<sup>476</sup> Finally, other economists support a dual-income tax system under which capital income is taxed at a low flat rate and labour income taxed at progressive rates.<sup>477</sup>

In summary, although tax policy commentators disagree on exactly how capital income should be taxed (eg not at all, at a low flat rate, at marginal rates bearing some relation to the marginal rates applicable to labour income, at the same rate as labour income), there currently is much support in the academic literature for taxing capital income differently than labour income—as is presently the case in the UK and most other countries.

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context of both theoretical findings in richer models and the available empirical econometric evidence. Hence such a result should be considered not robust enough for applied policy purposes and there should be some role for including capital income as a component of the tax base’).

<sup>475</sup> Banks and Diamond (n 34) 3. Hall is not convinced by the authors’ thesis that capital taxation is a better idea than economists generally think, and is particularly critical of their failure to arrive at a concrete proposal: see Robert E Hall, ‘The Base for Direct Taxation: Commentary’ prepared for James Mirrlees and others (eds), *Reforming the Tax System for the 21st Century: The Mirrlees Review* (The Institute for Fiscal Studies, London 2008) <<http://www.ifs.org.uk/mirrlees/mrPublications>> accessed 30 March 2009, 6 and 11 (‘One obvious reason that the chapter is unpersuasive is that it makes no attempt to provide a number. Did the United States move in the right or wrong direction in 2003 when it cut dividend and capital gains rates? Should Britain have a 10-percent or a 60-percent top rate on capital income?’).

<sup>476</sup> Banks and Diamond (n 34) 3. The authors leave unanswered the question as to whether capital income should be taxed more heavily or more lightly than labour income, concluding that more research is needed.

<sup>477</sup> Griffith, Hines and Sørensen (n 83). The dual-income tax is discussed in more detail below; see text at n 499.

## (b) Taxation of Labour Income from Business Activities

As briefly discussed in Chapter 2,<sup>478</sup> in some situations activities carried on by self-employed persons—even one-person companies—that gives rise to business income for tax purposes appears functionally similar to activity carried on by employees. Employees may even attempt to disguise what is clearly employment income as business income in an attempt to take advantage of the generally more favourable tax treatment accorded business income.<sup>479</sup> For present purposes, however, the key concern is the treatment of business activities that would not be characterised as arising in an employment under the usual legal tests,<sup>480</sup> but are nevertheless similar enough to activities undertaken by employees to potentially justify the label and tax treatment of ‘labour income’. Consider the following three fact patterns:

E is an employee working in the information technology (IT) department of a large company. E provides his services at a number of the company’s offices around the UK. E is paid a salary plus a performance-related bonus.

S is self-employed providing IT services to a small number of clients on long-term contracts. S has no employees and little capital invested in the business.

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<sup>478</sup> Chapter 2, text at n 61.

<sup>479</sup> Crawford and Freedman (n 94) [III.2.3]; Freedman (n 96) 130-141. For example, the rules governing deduction of expenses are more generous for the self-employed than for employees. Employees also pay higher NICs and there is no equivalent to the employer NICs for self-employed persons.

<sup>480</sup> Whether a UK worker is an ‘employee’ and thus subject to employment tax on his or her earnings is determined under fact-dependent common law tests aimed at distinguishing a contract ‘of’ service (employment) from a contract ‘for’ service (self-employed). See Tiley (n 23) [13.2], Crawford and Freedman (n 94) [III.2.3] and Freedman (n 96) 42-49.

C provides similar services as S but through a company C owns 100%. C is the sole director, the only employee, and the company has little in the way of capital requirements.

In all three fact patterns, a similar economic activity is being undertaken by E, S and C though in different legal forms—employment, unincorporated business, and incorporated business, respectively. The UK tax consequences, however, could vary substantially. Crawford and Freedman compared the tax and NIC (employee plus employer) charge across legal forms and found for income/profits of £75,000 per annum the total tax (income and corporations tax) and NIC as a percentage of gross income/profits was 37.7% for the employed, 31.8% for the self-employed and 24.5% if earned through a company.<sup>481</sup> Following the increase in the top rate of income tax to 50% announced in Budget 2009, some advisors expect ‘a rush’ of high-income earners moving to a corporate structure to save on tax.<sup>482</sup>

Such difference in tax treatment is potentially distortionary as it may lead to a choice of business form that is not the most appropriate and efficient in the particular circumstances.<sup>483</sup> Inconsistent tax treatment of various forms of business organisation also penalises some activities that are unable to adopt the most advantageous form of organisation.<sup>484</sup> Furthermore, the difference in combined tax and NIC treatment on similar economic activities is undesirable because it creates incentives for taxpayers to

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<sup>481</sup> Crawford and Freedman (n 94) Appendix III, Table III.1 using tax rates in effect for 2009-10.

<sup>482</sup> Mike Warburton of Grant Thornton interviewed in Budworth (n 9) and Tony Bernstein of HW Fisher, chartered accountants, interviewed in Colman (n 8).

<sup>483</sup> Meade Report (n 13) 9.

<sup>484</sup> Carter Commission (n 13) Vol 1, 25.

convert income from labour into income from capital.<sup>485</sup> Ideally, the tax system should be neutral to business form and should aim to align the effective tax rates on employees, unincorporated businesses and incorporated businesses after taking into account capital investment.<sup>486</sup> In this vein, Gammie contends that '[p]ersons with similar outcomes should face similar tax burdens and it should be irrelevant whether those outcomes arise from conducting their own business or from offering their services as employees.'<sup>487</sup>

The extent to which business and employment activities can ever be considered similar is, however, the matter of some debate. Redston contends that business activities bear little resemblance to employment activities and thus any comparisons between the tax of employees and business owners are meaningless.<sup>488</sup> For example, employees have a range of benefits and protections not available to businesspersons (eg paid holidays, fixed working hours).<sup>489</sup> Whilst this is true, it is likely that these differences are taken into account, at least to some extent, by the operation of the market. The fact that E faces less risk as an employee should be reflected in his salary level; conversely although S and C are taking on greater risk, they also enjoy potentially greater rewards. Redston also argues that family businesses depend on contributions (not necessarily equal ones) from more than one participating family members. Employees, on the other hand, may discuss

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<sup>485</sup> Crawford and Freedman (n 94) [I.1].

<sup>486</sup> Crawford and Freedman (n 94) [I.1].

<sup>487</sup> Gammie (n 61) 692.

<sup>488</sup> Redston (n 62) 681.

<sup>489</sup> Redston (n 62) 681.

their work with their spouses, but it is not essential in the same way it is for many family businesses.<sup>490</sup>

Crawford and Freedman respond by arguing there is a spectrum of worker activity.<sup>491</sup> At one end of the spectrum is a standard, full-time employee, subject to direct supervision and earning a wage in return for supplying his personal services. At the other end is an incorporated business with a large number of shareholders. There are also boundaries within this spectrum—the boundary between employment and self-employment and between unincorporated and incorporated businesses.<sup>492</sup> On either side of these boundaries lies the ‘grey area’ with the tough cases, those with attributes of both. When viewed in this way, it is not difficult to contend that some ‘grey area’ activities legally characterised as business activities will lie close enough to the employment end of the spectrum to be fairly described as labour income. Other business activity, of course, will lie further away from the employment end of the spectrum, giving rise to income that is a mix of labour and capital income. Income arising from those business activities that can be fairly described as giving rise to labour income should be subject to a similar level of tax as employment activities. Such similar treatment of similar outcomes is justifiable on both horizontal equity and neutrality grounds. Taxpayers should not be faced with either tax incentives or disincentives to adopt one legal form of economic activity over

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<sup>490</sup> Redston (n 62) 681.

<sup>491</sup> Crawford and Freedman (n 94) [I.1]. See also Freedman (n 96) 13-14.

<sup>492</sup> Crawford and Freedman (n 94) [I.1].

another (possibly less appropriate or efficient); choice of legal form should be dictated by business reasons.<sup>493</sup>

In summary, from a policy perspective it may well be appropriate in some cases to characterise business income (ie self-employment earnings, partnership profits, and even company profits) arising from employment-like activities as labour income. The tax treatment and income attribution model that applies for employment is just as appropriate for these business profits, especially in the case of a one-person personal services business (incorporated or unincorporated) requiring little if any capital. The businessperson is, in Zelenak's words, closer to the income than anyone else could be. Thus, in the example of E, S and C above, the income of S and C could be fairly described as 'labour income', and the tax treatment—as well as the approach governing attempts to income split—should ideally parallel that applicable to E's income from employment.

### (c) Taxation of Mixed Labour and Capital Income

A further complication arises in considering how to tax income derived from an incorporated or unincorporated business that is further along the spectrum away from the employment end. In such case the profits represent a mixture of return on labour and return on capital invested, with the distribution between the two forms depending upon

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<sup>493</sup> Chapter 6 returns to this issue when considering reforms to enhance the neutrality of the UK tax system; see text at n 959.

where the activity falls on the spectrum.<sup>494</sup> If labour income and capital income are taxed at the same rate the treatment of mixed capital and labour income is of little practical importance.<sup>495</sup> If, however, capital income is taxed at a lower rate than labour income (as it is in the UK), or subject to different attribution rules, this appropriate treatment of mixed income must be addressed. The analysis that follows assumes only one taxpayer is generating the mixed income, either as self-employment earnings or through a ‘one-man’ company. The more complicated question of attributing mixed income from the joint activity of two or more taxpayers (eg in a husband and wife partnership or a family company) is considered later in this Chapter.<sup>496</sup>

The present UK approach to taxing self-employment income is not to attempt to dissect the income into its labour and capital components and tax those amounts accordingly, but rather to apply a tax treatment distinct from that applicable to either employment or capital. The resulting combined tax and NIC rate lies somewhere between that applicable to employment earnings, on the one hand, and capital income, on the other hand.<sup>497</sup> In contrast, an owner-manager of an incorporated business can withdraw business profits in the form of labour income (eg salary, director fees, and bonuses) or capital income (eg dividends or capital gains from selling shares in the company) or a combination of both. If the tax system permits taxpayers to self-select the form their

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<sup>494</sup> Crawford and Freedman (n 94) [I.1]. They suggest a third category is also possible—a return to risk taking or entrepreneurship, though point out these factors are not easily measurable and ‘it is not entirely clear whether income representing a reward for these factors should be taxed as a return to capital or in the same way as labour income (or in some other way)’.

<sup>495</sup> Arguments in favour and also against taxing labour and capital income at the same rate are considered above: see text at n 438.

<sup>496</sup> Text at n 615.

<sup>497</sup> Text at n 481.

income takes, and the system taxes labour income more heavily than capital income (as in the UK), taxpayers will have an obvious incentive to attempt to convert higher-taxed labour income into lower-taxed capital income, by, for example, incorporating their business activities and taking their compensation in the form of lightly-taxed dividends rather than salary or self-employment earnings.<sup>498</sup>

An alternative, and conceptually stronger, method for arriving at a division of mixed labour and capital income in a system in which labour income is taxed more heavily than capital income is the approach taken under a Nordic-style dual income tax (DIT). The DIT is a schedular income tax that combines a progressive tax on labour income with a low flat rate of tax on income from capital.<sup>499</sup> In its purest form, capital income under the DIT includes interest, dividends, capital gains, rental income, and also imputed returns on owner-occupied housing.<sup>500</sup> Ideally, the personal tax rate on capital income is aligned with both the lowest marginal rate applicable to labour income and also the tax rate on corporate profits.<sup>501</sup> The relationship among these tax rates is absolutely critical to the successful operation of the DIT.<sup>502</sup>

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<sup>498</sup> This form of tax arbitrage is discussed above: see text at n 92.

<sup>499</sup> Griffith, Hines and Sørensen (n 83) 72-77. See also Peter Birch Sørensen, 'The Nordic Dual Income Tax – In or Out?' (Speech delivered at the meeting of Working Party 2 on Fiscal Affairs, OECD) (14 June 2001) <<http://www.econ.ku.dk/pbs/diversefiler/oecddual.pdf>> accessed 21 April 2009.

<sup>500</sup> Sørensen (n 499) 8.

<sup>501</sup> Sørensen (n 499) 8.

<sup>502</sup> According to Griffith, Hines and Sørensen (n 83) 73, 'if the corporate income tax rate is  $t^c$  and the top marginal tax rate on labour income is  $t^l$ , the capital income tax rate  $t^f$  should be set such that  $(1 - t^f)(1 - t^c) = 1 - t^l$  to prevent tax avoidance through income shifting'. As explained in the opening introduction to this thesis, 'income shifting' in this context means the conversion of labour income into capital income.

Importantly for present purposes, in order to ensure that investment in business assets is treated in the same manner as other forms of investment, the DIT imputes a rate of return to the business assets of proprietorships and partnerships and taxes this return as capital income. The residual business income is then taxed as labour income.<sup>503</sup> Alternatively, owners can opt out of DIT treatment (eg to save on compliance costs) and have their entire business income taxed as labour income. Applying the DIT to unincorporated businesses gives rise to several difficult practical problems, however, including how to separate a proprietor's business assets from his or her non-business assets, whether non-acquired goodwill should be treated as capital, and choosing the imputation rate.<sup>504</sup> It also places a significant compliance burden on small business owners, which they can opt out of but at the expense of paying higher tax.

The DIT's approach to the mixed labour and capital income issue in the taxation of small corporations is particularly interesting. Since capital income is subject to a lower, flat tax rate compared to labour income under the DIT, in a situation in which corporate profits are subject to a low rate of tax, a controlling shareholder who is also a company employee has an obvious incentive to take out his or her income as lightly-taxed dividends or capital gains on his shares rather than as wages and salaries (as is also the case under the present UK tax system). The tax system in operation in Norway between 1992 and 2006, as well as the Swedish tax system, faced this problem when those countries decided to fully eliminate the double taxation of corporate equity

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<sup>503</sup> Griffith, Hines and Sørensen (n 83) 73.

<sup>504</sup> Sørensen (n 499) 9-10.

income.<sup>505</sup> Policy makers in Sweden and Norway decided that an imputed rate of return on the share of corporate assets owned by ‘active’ owners of closely-held companies should be taxed as capital income, whereas the residual part of the owner’s share of corporate profits should be taxed as labour income.<sup>506</sup> As a result, the overall tax liability of active shareholders does not depend upon the way in which they take income out of the corporation. Moreover, this method has the highly-desirable advantage of ensuring equal and neutral tax treatment of proprietorships, partnerships and small incorporated businesses.<sup>507</sup>

It immediately becomes apparent, however, that this approach to taxing shareholders depends upon the definition of ‘active’. Crawford and Freedman criticise the Swedish and pre-2006 Norwegian models on this point.<sup>508</sup> Sorensen concedes that the separation of so-called ‘active’ from ‘passive’ shareholders is bound to involve some arbitrariness, and the complex definitions adopted in pre-2006 Norwegian tax law created considerable controversy.<sup>509</sup> He points to Finland as an example of how this difficulty can be avoided. Finnish tax law requires that dividends paid by all corporations which are not listed on an official stock exchange be split into a capital income component subject to the flat capital income tax rate, and an earned income component subject to the

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<sup>505</sup> Sørensen (n 499) 11; Crawford and Freedman (n 94) [IV.2.4].

<sup>506</sup> Sørensen (n 499) 11; Crawford and Freedman (n 94) [IV.2.4]. Presentation by Professor Peter Melz at Cambridge Tax Centre seminar (Cambridge 17 October 2008).

<sup>507</sup> Sørensen (n 499) 11.

<sup>508</sup> Crawford and Freedman (n 94) [IV.2.4].

<sup>509</sup> Sørensen (n 499) 10.

progressive labour income tax.<sup>510</sup> Post-2006, Norway opted instead for a shareholder income tax combined with a rate of return allowance (RRA). The RRA exempts all shareholder income—dividends and also capital gains—below an imputed normal rate of return on the share basis (ie cost of the shares plus unutilised RRA from previous years).<sup>511</sup> Income above the normal rate of return is taxed as capital income, which when combined with the corporation tax approximates the top marginal tax rate on labour income. In this way, the incentives to convert labour income into capital income are greatly reduced.<sup>512</sup> This approach has the advantage of taxing all shareholders in the same way, eliminating the definitional problems associated with tests like ‘active’ shareholders and ‘close companies’.<sup>513</sup> This model is also favoured by some economists because exempting the normal return on savings from income tax avoids the intertemporal tax distortion to the choice between present and future consumption—effectively moving the personal income tax towards a consumption tax.<sup>514</sup>

In summary, a Nordic-style DIT provides an interesting solution to the problem of separating the capital and labour components of business profits for both incorporated and unincorporated businesses in a way that does not rely on taxpayers choosing the form their income takes. Once the income has been dissected into its capital and labour

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<sup>510</sup> Sørensen (n 499) 10.

<sup>511</sup> Crawford and Freedman (n 94) [IV.3.2.1] and Griffith, Hines and Sørensen (n 83) 78.

<sup>512</sup> Crawford and Freedman (n 94) [IV.3.2.1]. The effect of social security contributions (of about 6%) are not taken into account.

<sup>513</sup> Crawford and Freedman (n 94) [IV.3.2.1] and Griffith, Hines and Sørensen (n 83) 80.

<sup>514</sup> Griffith, Hines and Sørensen (n 83) 78 and see discussion of consumption tax at n 472. The philosophy behind the RRA model can be extended to the corporate tax by means of an allowance for corporate equity (ACE), whereby companies are allowed to deduct an imputed normal return on equity in computing taxable income (paralleling a deduction for interest expense): Griffith, Hines and Sørensen (n 83) 65-72 and 79.

components, the usual tax rates and attribution rules can then be applied. On the other hand, the DIT imposes significant compliance costs on small business persons and raises difficult practical problems such as how capital is defined and what a normal rate of return is. The strengths and weaknesses of the DIT as a structural reform option for the UK to address income-splitting arrangements and advance neutrality in the taxation of family businesses regardless of legal form will be considered further in Chapter 6.

## 2. ATTRIBUTION OF LABOUR INCOME

Returning to the central issue in this Chapter—the attribution rules applicable to different types of income—as noted above, earnings from employment constitute the largest source of income, and tax revenue on income, in the UK, and are almost always taxed in the hands of the employee. It is very difficult for UK employees to shift income (and the corresponding tax liability) to another taxpayer such as the employee’s spouse. This position reflects the control approach to income: earners always have a closer connection to their earnings than anyone else can possibly have and thus earners alone should be taxed on their earnings.<sup>515</sup> As discussed in the previous Chapter, the US takes a similar approach under the ‘assignment of income’ doctrine emanating from the US Supreme Court decision in *Lucas v Earl*.<sup>516</sup>

In the UK, specific statutory rules apply to tax payments or other benefits provided by an employer to family members of an employee as employment income of

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<sup>515</sup> See text at n 429.

<sup>516</sup> Text at n 197.

the employee. These rules have the effect of greatly restricting employees from engaging in tax-motivated income shifting.<sup>517</sup> For example, pursuant to section 201 of ITEPA (the residual benefit code liability to charge) an ‘employment-related benefit’ is defined to include a benefit for an employee or for a member of an employee’s family or household provided by reason of the employment. Importantly, a benefit provided by an employer is by default to be regarded as provided by reason of the employment unless (a) the employer is an individual, and (b) the provision is made in the normal course of the employer’s domestic, family or personal relationships. Similar rules apply to specific benefits such as employer-provided living accommodation.<sup>518</sup> These broad deeming rules alleviate HMRC from the burden of a difficult fact-based inquiry into the actual purpose and context of the benefit. Given the breadth of this rule it is unsurprisingly that they may in some situations be over-inclusive.<sup>519</sup>

Not all tax commentators are in favour of a control-based approach to the taxation of employment earnings. Certainly this includes supporters of the benefit approach such as McIntyre and Oldman, but others also argue that some tax-effective assignments of employment income within the family should be permitted on other grounds. Such a system encourages husbands to share legal ownership of their earnings with their non-earning or lower-earning wives, in order to obtain the tax benefit of income splitting (as

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<sup>517</sup> ITEPA s 201.

<sup>518</sup> ITEPA s 97. See also ITEPA s 205 (asset made available without transfer). The expression ‘family or household’ is defined in ITEPA s 721 and includes a person’s spouse, children and their spouses, parents, domestic staff and guests.

<sup>519</sup> Tiley, somewhat irreverently, illustrates this point with an example of flowers given to an employee’s wife by the managing director of her husband’s employer; this gift would likely give rise to a tax liability for the husband, whether or not the husband approved of the gift: Tiley (n 23) 292.

witnessed after *Poe v Seaborn*).<sup>520</sup> Gann is attracted by the behavioural effect of this approach.<sup>521</sup> She argues for reform of US marital property laws to protect the interests of non-earning and low-earning wives in the event of divorce; a system of separate returns that permits income splitting premised upon a wife's ownership of a husband's earnings is a move towards encouraging such reform.<sup>522</sup>

Notwithstanding these arguments, a shift from the current system attributing employment earnings (including payments and benefits provided to family members of the employee) for tax purposes to the employee generating those earnings is a fundamental and unlikely change. Furthermore, as discussed above, from a policy perspective it may well be appropriate in some cases to characterise business income (ie self-employment earnings, partnership profits, and even company profits) arising from employment-like activities as labour income.<sup>523</sup> In this event, those profits should also be subject to the control attribution rule. The next section examines various alternative models, including the control model, for attributing capital income to taxpayers.

### 3. ATTRIBUTION OF CAPITAL INCOME

Whilst there is much debate over the *levels* of taxation appropriate for labour versus capital income, the question at issue for present purposes is whether the same model for

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<sup>520</sup> Kesselman (n 190) 24-36. See discussion of *Poe v Seaborn* in Chapter 3 at n 200.

<sup>521</sup> Pamela Gann, 'Abandoning Marital Status as a Factor in Allocating Income Tax Burdens' (1980) 59 Texas L Rev 1, 50.

<sup>522</sup> Gann (n 521) 64-68. Gann ultimately rejects this approach because in her view the US Congress would not extend similar income-splitting opportunities to unmarried persons, and without that extension the law would be unfair.

<sup>523</sup> See text at n 478.

attributing income to individual tax units (namely the control model) is appropriate for both. The previous section concluded that the control model is indeed appropriate for the attribution of labour income, and moreover, that labour income includes income from employment and in some cases income from business activities. This section considers the suitability of the control model and other possible alternatives for allocating income from capital, eg rent, bank interest and dividends on quoted shares.

Capital income is more problematic for a control-based approach to income attribution because, unlike the case for labour income (or at least employment income), it is relatively easy for a taxpayer to income shift. Income-producing assets—and the consequent tax liability—can be gifted by a high-income taxpayer to a lower-income family member with the result that future income from those assets will be subject to a lower rate of tax. The actual distribution of assets amongst family members may be of little practical concern for the family,<sup>524</sup> but the result will be a lower overall family tax liability and lower tax revenues for the Treasury. Following the increase in tax on top earners announced in Budget 2009 accountants expect their wealthy clients will undertake more such tax-motivated transfers.<sup>525</sup>

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<sup>524</sup> Bittker notes that the US tax system has considered these ‘bedchamber transactions’ as suspect on the basis that the allocation of legal rights within the family is a trivial matter: (n 194) 1394. He goes on to suggest, however, that legal rights may be far from unimportant and that tax theorists may have ‘excessively downgraded’ the importance of legal rights within the family. Feminists and others would disagree with the assertion that property ownership in marriage is a trivial matter: see text at n 531.

<sup>525</sup> Goff (n 9) (‘Those hit by the new 50 per cent tax rate, for example, could reduce their income by handing assets such as share portfolios and properties to lower-earning spouses.’). Similar advice is provided in Budworth (n 9).

Redston argues that allowing this form of passive income splitting by well-off taxpayers whilst at the same time attempting to restrict income-splitting by mainly low- and middle-income family business persons is unjustifiable on a policy basis and manifestly unfair.<sup>526</sup> Unfairness in this context appears to mean vertically inequitable, and, as will be seen, other policy considerations such as work incentives, privacy/autonomy and administration/compliance costs are also relevant. Before proceeding it is worth remembering that, for the reasons discussed earlier, on a practical level the attribution of capital income is less important than the allocation of labour income simply because there is much less tax revenue at stake.<sup>527</sup>

Four prominent models for the attribution of capital income to tax units are examined next:

1. Tax the income to the owner of the income-producing asset;
2. Tax the income according to ownership, except do not give tax effect to interspousal transfers of income-producing assets;
3. Allocate capital income equally between the spouses;
4. Allocate all capital income to the higher-earning spouse.<sup>528</sup>

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<sup>526</sup> Redston (n 62) 681.

<sup>527</sup> Text at n 448.

<sup>528</sup> See eg Zelenak (n 194) 385; Kesselman (n 190) 22-26.

These various options, along with examples of their use in practice, are examined next. Considerable attention will be paid to the first two options in particular. Before proceeding, it should be noted that Options 2-4 (but not Option 1) requires the tax system to define the 'spouse' for allocation or tracking purposes, thus raising the same difficult definitional problem discussed at length in the previous Chapter on tax unit.<sup>529</sup> Also, as Options 3 and 4 rely on allocation models, these options will be considered together.

#### (a) Option 1: Ownership/Control

Assigning capital income according to legal ownership is consistent with the control approach already considered to be the most appropriate principle for attribution of labour income, assuming that the legal owner has effective control over the income-producing assets as well. It is also the primary method of attributing capital income used in the UK. A key advantage of allocating income from capital on the basis of ownership/control is that this option is truly marriage neutral; all the other options take marriage into account in determining tax liabilities.<sup>530</sup> It thus also avoids the thorny issue faced by the other three options of defining a 'spouse'.

In addition, some tax commentators support this option on the basis that it encourages gifts of income-producing assets to non-earning and low-earning spouses,

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<sup>529</sup> Chapter 3, text at n 217.

<sup>530</sup> Zelenak (n 194) 385.

generally wives.<sup>531</sup> This result is seen as socially desirable as it goes some way towards reducing the disparities in the distribution of wealth between husbands and wives. It also gives wives their own source of (recurring) income.<sup>532</sup> Furthermore, the lower-income wife may be able to sell some or all of the assets if necessary or borrow against their value. The potential tax benefits from income splitting alone, however, may not automatically lead to a transfer of assets from husbands to wives. Those especially secure in their marriages and those especially eager for tax savings will take full advantage; others will not.<sup>533</sup>

Freedman and others<sup>534</sup> have considered this issue in the context of arguing for reforms to marital property law to encourage community ownership of property. They support individual taxation of capital income according to actual ownership of the underlying property and view the fiscal incentives for spouses to transfer property between them to minimise tax as a positive: ‘It seems entirely consistent with our aim to encourage community property by allowing only those who actually adopt co-ownership or equally split ownership of assets during marriage to reap the tax benefits of this arrangement’.<sup>535</sup> They conclude that fiscal motives should not be viewed as problematic in this context: ‘If the transfers are genuine, then they should be tax-effective. This is not

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<sup>531</sup> See eg Louise Dulude, ‘Taxation of the Spouses: A Comparison of Canadian, American, British, French and Swedish Law’ (1985) 23 Osgoode Hall L J 67, 104; Gann (n 521) 50-51; Kesselman (n 190) 36; Brooks (n 223) 74. This argument was also noted in the Meade Report (n 13) 384.

<sup>532</sup> Kesselman (n 190) 24; Brooks (n 223) 74; Maureen Donnelly, Joanne Magee and Allister Young, ‘Income Splitting and the New Kiddie Tax: Major Changes for Minor Children’ (2000) 48 Can Tax J 979, 1008.

<sup>533</sup> This leads to what Zelenak calls a ‘happy marriage tax bonus’: Zelenak (n 194) 386.

<sup>534</sup> Freedman and others (n 163).

<sup>535</sup> Freedman and others (n 163) 107.

an encouragement of transfers for purely fiscal reasons, but the provision of a tax incentive for genuine sharing of property'.<sup>536</sup> Brice arrives at a similar conclusion.<sup>537</sup>

The key question, then, is when transfers of assets between spouses are 'genuine' such that ownership should be determinative for income-attribution purposes. Duff argues that adult spouses have effective control over the income to which they are legally entitled.<sup>538</sup> Others take the position that whether transfer of legal title is equivalent to transferring control will depend on the dynamic of the couple's relationship.<sup>539</sup> Philipps would require clear evidence of transfer of effective control over the asset as opposed to a mere formal transfer aimed at reducing the transferor's tax.<sup>540</sup>

In addition to this concern over transfer of formal but not effective control, Option 1 suffers from other drawbacks. The first is that it rewards those couples who are well-advised (ie Redston's vertical inequity argument). It also encourages the inefficient use of resources in tax planning, and triggers administrative costs associated with that tax planning and the concomitant transfer of assets. Finally, and most importantly, if as a result of interspousal asset shuffling enough capital income is generated in the hands of

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<sup>536</sup> Freedman and others (n 163) 126.

<sup>537</sup> Brice (n 154) 627 ('The view is therefore taken that there is no justification for refusing to recognise as tax effective genuine bona fide transfers of income producing assets between spouses...').

<sup>538</sup> David G Duff, 'Neuman and Beyond: Income Splitting, Tax Avoidance, and Statutory Interpretation in the Supreme Court of Canada' (1999) *Can Bus L J* 345, 379.

<sup>539</sup> Kesselman (n 190) 24; Philipps (n 337) 1036 ('As every estate planner and family lawyer understands, informal power dynamics are at least as important as legal rights in determining who really controls a family business or other assets').

<sup>540</sup> Philipps (n 337) 1035 ('...women holding legal title to more property...is rather meaningless if it is not understood by the spouses, as well as by third parties, to signify a real change in beneficial ownership and de facto control over the property'). Lahey would require 'tests designed to indentify genuine economic autonomy': (n 307) 119.

the lower-income spouse to use up her personal allowance this may create a disincentive for her to work outside the home as the first pound of her labour earnings will be subject to tax (as discussed in Chapter 3).<sup>541</sup>

### (b) Option 2: Ownership Combined with Spousal Attribution

Option 2 is to tax income according to ownership, but not to give tax effect to interspousal transfers of income-producing assets. In other words, Option 2 begins with the ownership/control basis of income attribution but aims to eliminate the tax benefits from interspousal transfers, ie transfers of income-producing property from a high-income spouse to a low-income spouse designed to minimise the couple's combined tax burden. As a result, where income-producing assets have been transferred from one spouse to the other, future income arising from those assets is attributed back to the transferor spouse and taxed in the transferor's hands. As already mentioned, this option has one obvious downside—it requires a definition of 'spouse', with all the difficulties that that entails.<sup>542</sup> It also imposes an administrative burden on the spouses to keep track of interspousal transfers, and to trace the income earned from those transfers (or possibly a subset of those transfers, with some transfers deemed acceptable and outside the scope of the regime as a matter of policy) on an ongoing basis. Despite these drawbacks, Canada has adopted the spousal attribution model. The Canadian experience will be examined in some detail next.

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<sup>541</sup> See discussion on work incentives at n 371.

<sup>542</sup> Discussed in Chapter 3; see text at n 217.

From the inception of the Canadian income tax in 1917, the basic unit of tax has been the individual. Following on from that choice, it is clear from the earliest beginnings of the Canadian income tax that legislators have been concerned with spouses transferring income-producing assets between themselves as a way to reduce their combined income tax burden. The Canadian Income War Tax Act 1917<sup>543</sup> had a mere 24 sections, but one of them, section 4(4), was aimed squarely at income splitting within the family.<sup>544</sup>

A person who, after the first day of August, 1917, has reduced his income by the transfer or assignment of any real or personal, movable or immovable property, to such person's wife or husband, as the case may be, or to any member of the family of such person, shall, nevertheless, be liable to be taxed as if such transfer or assignment had not been made, unless the Minister is satisfied that such transfer or assignment was not made for the purpose of evading the taxes imposed under this Act or any part thereof.

The rule was drafted in broad, simple language and left considerable discretion to the tax authorities to determine if the transaction at issue could be justified on grounds other than tax savings.

Presently, the Canadian Income Tax Act (CITA) contains many specific provisions directed at countering family income-splitting arrangements. In general, these 'attribution rules' operate in a manner similar to the original 1917 rule: income earned by, or belonging to, one is treated for tax purposes as the income of another. For present

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<sup>543</sup> 7-8 Geo 5, c 28.

<sup>544</sup> SC 1917 c 28. It is interesting to note the use of the term 'evading' to describe arrangements that would be more likely to be characterised today as mere tax planning, mitigation, or at worst avoidance. The terms avoidance and evasion appear to have been used interchangeably at that time.

purposes, the primary Canadian rules aimed at thwarting income-splitting arrangements are found in sections 74.1, 74.2 and 74.4 of the CITA. An anti-avoidance rule prevents these rules from applying to a transfer or loan of property where it may reasonably be concluded that one of the main reasons for the transfer or loan was to reduce the amount of tax that would otherwise be payable.<sup>545</sup> The general anti-avoidance rule in section 245 of the CITA may also restrict attempts to (mis)use the attribution rules to generate tax savings from family income splitting.<sup>546</sup>

The main spousal attribution rule is found in CITA section 74.1(1). Pursuant to this provision, where an individual transfers or loans property, directly or indirectly, to or for the benefit of his or her spouse or common-law partner, any income (or loss) earned by the recipient spouse/partner on the transferred or loaned property (or substituted property) will be attributed to the transferor and taxable as his or her income (or loss). Back-to-back loans, involving a loan to a third party who then makes a loan to the first lender's spouse/partner, are also caught, as are loans guaranteed by the debtor's spouse/partner.<sup>547</sup>

Interestingly, and to further complicate matters, certain transfers are excluded from the attribution regime. For example, if the transferred or loaned property is used to earn business income, the attribution rules do not apply—the rule is aimed only at attempts to shift passive or unearned income (referred to in the CITA generally as

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<sup>545</sup> CITA ss 74.5(11).

<sup>546</sup> *Lipson v Canada* 2009 SCC 1. This case is discussed further in Chapter 6: see text at n 1054.

<sup>547</sup> CITA ss 74.5(6), (7) and (8).

‘income from property’), such as dividends and interest.<sup>548</sup> This point was established in a case concerning the investment of transferred funds from one spouse in the real estate business of the other spouse.<sup>549</sup> Young speculates that this limitation may reflect the administrative difficulty involved in attempting to trace business income back to certain transferred or loaned property.<sup>550</sup> Transfers for fair market value consideration also will not be caught by the rule, nor will loans made where the borrower is charged a commercial rate of interest (or a prescribed rate, if lower) and the interest is in fact paid no later than 30 days after the end of the tax year.<sup>551</sup> In addition, income earned on attributed income is not attributed. This exclusion may again be for administrative reasons but excluding compound interest represents a significant loophole. Section 74.2(1) provides similar tax treatment for capital gains (losses) arising from transferred property – the gain (loss) is attributed back to the transferor. Notably, the modern version of the spousal attribution rule no longer contains a tax-avoidance motive limitation like that found in the 1917 provision.

Section 74.1(2) of the CITA prescribes a similar income attribution rule for transfers or loans to related minor children (including nieces and nephews) of the taxpayer. Capital gains earned by minors generally are not subject to attribution; there is no equivalent to CITA section 74.2 for minors, other than in relation to certain farm

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<sup>548</sup> Canada Revenue Agency, *Interpretation Bulletin IT-511R2* (21 February 1994) [5].

<sup>549</sup> *Robins v Minister of National Revenue* 63 DTC 1012 (Exch Ct), concerning the interpretation to be placed on the phrase income ‘from property’ in an earlier version of the spousal attribution rule in section 21(1) of the Income Tax Act 1952.

<sup>550</sup> Claire F L Young, ‘The Attribution Rules: Their Uncertain Future in Light of Current Problems’ (1987) 35 Can Tax J 275, 294.

<sup>551</sup> CITA s 74.5.

property received on a tax-deferred basis.<sup>552</sup> These rules depart from the general position under Canadian income tax law that minors are treated as taxpayers in their own right, with their own personal tax credits and marginal rates. In addition, the so-called ‘kiddie-tax’ in CITA section 120.4 introduced in 2000 levies a tax charge at the highest marginal rate on an minor’s ‘split income’ for a tax year, which is basically income earned by the minor from dividends on private company shares and business income earned through a trust or partnership that is related to the business of a related individual.<sup>553</sup> This rule effectively ended the ability of high-income earners such as partners in large law firms to split their earnings with minor children through, for example, trusts, partnerships or companies providing management or support services to their law partnerships, thereby generating profits which could be distributed to their minor children and taxed at lower marginal rates, if at all.

The Canadian attribution rules have been criticised as largely ineffective. Notwithstanding the broad terms used in CITA section 74.1, such as ‘directly or indirectly’ and ‘by any means whatsoever’, the rules have not operated in a broad way in practice. The Canadian courts have historically applied a narrow, literal interpretation to the rule, resulting in successive legislative amendments to plug holes that, arguably, would not have needed to have been plugged had the provision been applied in a more

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<sup>552</sup> CITA ss 73(3), (4) and 75.1.

<sup>553</sup> CITA s 120.4. See also Donnelly, Magee and Young (n 532) 979 and Kathy Munro, ‘The Attribution Rules and the Proposed Income Splitting Tax’ *1999 Ontario Tax Conference Report* (Canadian Tax Foundation, Toronto 1999) 13:1.

purposive way. Most notably, the provision was amended to expressly include ‘loans’ within its ambit after the word ‘transfer’ was held not to be broad enough to so apply.<sup>554</sup>

Furthermore, many taxpayers are able to structure their affairs in such a way as to fall outside the scope of the attribution provisions while still obtaining the desired income-splitting benefits. For example, the higher-income spouse can pay all the personal and living expenses of the low-income spouse thereby allowing the low-income spouse to invest whatever earnings he or she does have from employment or other sources without risk of attribution.<sup>555</sup> Proper tracing of the source of the invested funds, by opening a separate bank account for the low-income spouse’s earnings and investments, is advised. Transfers to adult children also generally are not caught by the attribution rules, though loans made to adult children (and other non-arm’s length individuals) where it can be established that one of the main reasons for the loan was to reduce or avoid tax may result in income being attributed back to the lender.<sup>556</sup> This rule is quite narrow in that it does not apply to gifts or transfers where legal title passes or where market value interest is charged and paid in the same way outlined above with respect to section 74.1.

In 1987 Young criticised the attribution rules for being drafted in a long, detailed style attacking specific income-splitting arrangements rather than taking a broader, more

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<sup>554</sup> *Denkelman v Minister of National Revenue* 59 DTC 1242 (Exch Ct), and see discussion in Young (n 550) 281, 287 and Pooja Samtani, ‘Facts and Fallacies of Conjugalities: The Attribution Rules Revisited’ (MTax thesis, University of Waterloo 2006) 8.

<sup>555</sup> See, for example, Certified General Accountants of Ontario, ‘Personal Tax Planning Guide’ (2007) <[http://www.cga-ontario.org/contentfiles/publications\\_promotions/ptp/splitting.aspx](http://www.cga-ontario.org/contentfiles/publications_promotions/ptp/splitting.aspx)> accessed 19 June 2007.

<sup>556</sup> CITA s 56(4.1).

purposive approach, like the 1917 rule.<sup>557</sup> As a result, Young argued that gaps were left in the legislation (such as how the forgiveness of a loan provided from one spouse to another is treated) and, conversely, that the rules lead to attribution in some unintended and unsuitable situations.<sup>558</sup> Nearly twenty years later, another writer found that these criticisms are still equally valid.<sup>559</sup> The Canadian approach is unattractive for other reasons as well. Most importantly, taxation of capital income on a strict ownership basis in order to encourage a more equitable distribution of assets between the spouses is undermined by attribution.<sup>560</sup> Duff as well as Freedman and others would argue that if the transfers between the spouses have substantial economic effect they should be respected notwithstanding their motivations.<sup>561</sup>

In summary, the ownership combined with spousal attribution model is difficult to administer, and, given the Canadian experience, not particularly effective either. Some tax-motivated transactions will be able to take advantage of loopholes in such a regime whilst other, non-fiscally motivated transfers will be caught. This option also discourages a fairer redistribution of assets amongst spouses, and undermines the privacy and autonomy of the spouses with respect to their tax affairs. As discussed in Chapter 3,

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<sup>557</sup> Young (n 550) 286.

<sup>558</sup> Young (n 550) 286-88.

<sup>559</sup> Samtani (n 554) 19-20.

<sup>560</sup> See text beginning at n 530.

<sup>561</sup> See text beginning at n 534.

respecting the privacy and autonomy of the spouses is one of the key reasons the UK adopted independent taxation of the spouses in the first place.<sup>562</sup>

### (c) Options 3 and 4: Allocation of Income between Spouses

Options 3 and 4 rely on different models for allocating capital income between spouses and are therefore considered here together. Option 3 allocates capital income equally between the spouses, and thus finds support from those who favour the benefit approach to income attribution.<sup>563</sup> Under Option 4, all capital income is allocated to the higher-earning spouse. Both of these options suffer from the same problem as Option 2 (control plus attribution) in that they require an operational definition of ‘spouse’. They similarly undermine the privacy and autonomy of the spouses with respect to their individual tax affairs. On the other hand, these allocation methods are simple to comply with as well as administer, especially in comparison to Option 2.

In addition to simplicity and ease of administration, an important positive feature of Option 3—allocating half of the couple’s total investment income to each spouse—is that it does not place a premium on the inefficient use of resources for tax planning. Bittker is especially critical of Option 1 (control) on this basis.<sup>564</sup> Furthermore, this option may be more vertically equitable in that it reduces the extent to which well-informed, high-income taxpayers are able to split income under Option 1 or Option 2

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<sup>562</sup> See discussion at n 173 and n 300.

<sup>563</sup> Text beginning at n 416.

<sup>564</sup> Bittker (n 194) 1394.

whilst also extending some benefits from income splitting to other, less-well informed and less well-off taxpayers.<sup>565</sup> In his criticism of the pre-1990 UK regime Kerridge favoured aggregation of husband and wife investment income, partly for tax avoidance reasons, but suggested using wider tax bands than for single persons or levying tax on only a proportion of the combined investment income (eg 2/3).<sup>566</sup> The Meade Committee considered the main disadvantage of a simple 50-50% split of investment income (referred to as ‘partial income splitting’) was differential treatment of earned and unearned income, and, like Kerridge, considered various modifications but could not agree on any one alternative.<sup>567</sup>

In the UK, capital income arising from some forms of investment property that is held jointly by a married couple or registered civil partners is split 50-50% for tax purposes irrespective of the actual division of ownership between the spouses as a matter of administrative convenience.<sup>568</sup> This deemed 50-50% rule applies to certain forms of unearned income only. Most obviously, it does not apply to property that is not held jointly, which narrows its scope considerably, but it does not cover all forms of investment income from jointly-held property either. Interestingly, this rule does not apply in the family business context—income arising from joint shareholding in a ‘close

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<sup>565</sup> Kesselman (n 190) 22.

<sup>566</sup> Kerridge (n 181) 94-97.

<sup>567</sup> Meade Report (n 13) 386-87. In the context of an income tax the Meade Committee also considered an ‘unrestricted quotient system’ under which both earned and unearned income are allocated 50-50 to each spouse, but rejected it on the basis of work disincentives for the secondary earner (at 387). Other variations including an unrestricted quotient system and a partial quotient system were also considered. The Committee concluded none of these options were perfect (at 391).

<sup>568</sup> ITA 2007 s 836.

company', which is basically a company controlled by no more than five people,<sup>569</sup> does not qualify. This rule also does not normally cover interest on joint bank or building society accounts because for such accounts each owner is entitled jointly to the whole account, and any income from it is paid to both parties jointly.<sup>570</sup> A couple can elect out of this default administrative position on an asset-by-asset basis by filing with HMRC a 'declaration' on Form 17 requesting to be taxed instead on the income corresponding to their actual ownership percentage (ie Option 1 treatment).<sup>571</sup> Couples cannot elect to be taxed on a percentage other than that corresponding to their actual ownership entitlement. The declaration must be made jointly.<sup>572</sup>

The option of evenly splitting capital income between spouses irrespective of actual legal entitlement/control is difficult to justify on policy grounds. As evidenced by the UK's 50-50% rule it allows a wealthy spouse to have control over a large percentage of joint property (eg 95%) and yet be taxed on a much smaller percentage of the income (only 50%). An option allowing 50-50% tax attribution combined with 100% ownership and control by one spouse is even more extreme. Option 3 is unsatisfactory as it provides significant tax benefits from income splitting whilst creating potential disincentive for the lower-income spouse to work outside the home if his or her personal allowance is used up in this way—without the advantage of at least requiring the higher-income spouse to give up actual control over the asset to the other spouse. Moreover, the couple must

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<sup>569</sup> ICTA 1988 ss 414-417.

<sup>570</sup> HM Revenue & Customs, Form 17 (February 2006) <<http://www.hmrc.gov.uk/forms/form17.pdf>> accessed 12 January 2009.

<sup>571</sup> ITA 2007 s 837.

<sup>572</sup> ITA 2007 s 837.

jointly elect out of this treatment, which can undermine their personal privacy and autonomy.

Option 4—allocating all capital income to the higher-income earning spouse—completely removes any income-splitting benefits as well as potential work disincentives for the lower-income spouse.<sup>573</sup> The higher-income spouse has no tax reason for transferring property to the lower-income spouse under this regime, but also faces no tax penalty under the income attribution rules for doing so. It is also the most progressive option for taxing capital income, and is reminiscent of UK rules in place from 1971 until 1990 that allowed married women to elect to be taxed separately on their earned income but taxed her investment income as her husband's.<sup>574</sup> For the reasons discussed earlier in this Chapter, some commentators would view the progressivity of this option as a positive feature whilst others would view it as a negative, depending on their position on the taxation of capital income generally.<sup>575</sup> If one's primary concern is eliminating the disincentive to married women entering the labour force, this option is the most attractive. On the other hand, this treatment may have disincentive effects for the high-income earner and also for single people to form a couple, as a single person's investment income that was formerly covered by his or her personal allowance or taxed at a low rate

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<sup>573</sup> Meade Report (n 13) 382-83, described under the heading 'A Radical Modification of the Present System'. An alternative option would be allocate income in proportion to the spouses' earned income. This option would create less of a disincentive to work outside the home as at least some outside earnings are required before capital income can be attributed. Any capital income so attributed would eat into the personal allowance, however, creating some disincentive.

<sup>574</sup> See text at n 166.

<sup>575</sup> See text beginning at n 438.

could become taxable at his or her partner's top marginal rate.<sup>576</sup> As discussed in Chapter 3, however, the evidence suggests that tax rules do not have a significant effect on decisions to marry or cohabitate.<sup>577</sup> Another significant drawback of this approach is that privacy and autonomy of the spouses is again undermined.

#### (d) Conclusion on Attribution of Capital Income

Taxing capital income on the basis of control or ownership (Option 1) is the most attractive option though it is not without its drawbacks. It places a premium on tax planning and may give rise to a disincentive for the lower-income spouse to work outside the home. Option 2 (control plus spousal attribution) is difficult and costly to administer, also rewards tax planning, and in practice is likely to be largely ineffective. Option 3 (50-50% allocation of capital income to each spouse) is simpler and easy to administer, but it provides the tax benefits from income splitting without requiring the higher-income spouse to part with control over his or her assets. Allocating all capital income to the higher-income earning spouse (Option 4) is also an attractive option for its simplicity, and the most progressive, but like Options 2 and 3 requires a functional definition of 'spouse' and places a burden to pay taxes on income on those who may have no power and control over that income. It also undermines the personal privacy and autonomy of each spouse in his and her tax affairs.

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<sup>576</sup> Meade Report (n 13) 383; Brice (n 154) 601-2; Kerridge (n 181) 95. Kerridge describes total aggregation of investment income as 'too harsh'.

<sup>577</sup> Text beginning at n 278.

Ultimately, Option 1 (control) is the only option that achieves true marriage neutrality – one of the primary arguments in favour of the individual as the tax unit.<sup>578</sup> The control that goes with genuine ownership has sufficient economic reality to justify respecting ownership for tax purposes, even as between spouses. It may also have the beneficial side effect of encouraging a more balanced level of property ownership between husbands and wives.

#### **4. CONCLUSION**

In conclusion, although there is much support in the academic literature for taxing capital income differently from labour income (including employment as well as some business activity close to the employment end of the spectrum), the control model is the most appropriate model for attributing both labour and capital income.

The next section introduces the further complication of attributing income to multiple taxpayers.

#### **D. ATTRIBUTION OF INCOME EARNED THROUGH JOINT ACTIVITY**

Attempting to describe income that has the legal characteristics of business profits as ‘earned’ or ‘labour’ income raises a number of challenges. The first has already been identified—in some cases close to the employment end of the activity spectrum business profits can be fairly described as labour income, but in many other cases the business

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<sup>578</sup> Zelenak (n 194) 390.

profits will reflect a mixture of returns on labour and capital. The second issue is that in all but the smallest 'one-man' businesses the profits arising (be it predominantly labour income or a combination of labour and capital income) is the product of more than one family member. How much of the joint income is then property attributable to each taxpayer?

The next section considers a straightforward example of attributing one form of income to the two or more taxpayers jointly responsible for earning the income. This is followed by a consideration of the more complicated issue of attributing mixed income earned through the joint activity of more than one taxpayer.

## **1. INCOME EARNED THROUGH JOINT ACTIVITY**

It can be difficult in a family business context to judge how much of the joint product of the family's efforts reflects each individual family member's contribution. For example, consider a small business carried on as a partnership. If the partners are unrelated, the tax system can be content to let the parties decide for themselves how to divide the results of their joint effort, expecting that each partner will be acting in his or her self-interest. With related parties, however, people cannot be presumed to always pursue their own self-interests—one party may be indifferent as to whether they personally receive compensation or compensation is instead paid to members of his or her family—which makes the parties' division of the joint product unreliable as an ideal basis for taxation.

Since the protection of self-interest cannot be relied upon, some other approach is necessary to ensure a fair and reasonable attribution of the partnership profits to each

family member, and to prevent a taxpayer diverting his or her partnership income to another taxpayer, thereby undermining the choice of individual as tax unit as well as the control principle of income attribution.

This issue is not unique to the taxation of family businesses; an analogy can be drawn with transfer pricing and corporate groups. This is considered next.

### (a) A Transfer Pricing Approach

The leading approach internationally to the transfer pricing challenge—championed in the transfer pricing guidelines promulgated by the OECD<sup>579</sup>—is the ‘arm’s length principle’, pursuant to which prices set for transactions between associated entities should, for tax purposes, be derived from prices which would have been applied by unrelated parties in similar transactions under similar conditions in the open market.<sup>580</sup> A major reason for the historical appeal of the arm’s length principle is that it provides broad parity of tax treatment between associated and independent entities, avoiding a concern discussed earlier<sup>581</sup> over the creation of tax advantages or disadvantages that distort their competitive positions.<sup>582</sup> In some situations the UK tax system imposes

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<sup>579</sup> Organisation for Economic Co-operation and Development, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD Publishing, Paris 2001) (the ‘OECD TP Guidelines’).

<sup>580</sup> OECD TP Guidelines (n 579) [1.6].

<sup>581</sup> See text at n 97 and n 483.

<sup>582</sup> OECD TP Guidelines (n 579) [1.7]. See also the discussion of neutrality in Chapter 2 above at n 97. The arm’s length principle is not the only possible approach to the transfer pricing problem. Another possibility is global formulary apportionment whereby the global profits of a group of associated entities are allocated to countries based on a pre-determined formula: see OECD TP Guidelines [3.58-.74].

arm's length tests on taxpayers; however, these are fairly limited and tend to focus on particular transactions rather than ongoing situations. For example, under section 17 of the TCGA 1992 a disposal of an asset otherwise than by way of a bargain at arm's length is treated as a disposal at the market value. Furthermore, a transaction between 'connected persons' is treated as a transaction 'otherwise than by way of bargain at arm's length'<sup>583</sup>; 'connected persons' for this purpose includes an individual's spouse / civil partner, brother, sister, ancestor or lineal descendant, as well as brothers, sisters, ancestors or lineal descendants of the individual's spouse / civil partner.<sup>584</sup>

A similar rule can apply in the income (and corporation) tax context where a trader appropriates trading stock for a non-trading related purpose, eg by giving it away to friends and family. Under the rule in *Sharkey v Wernher*,<sup>585</sup> recently (and somewhat surprisingly<sup>586</sup>) codified in Finance Act 2008,<sup>587</sup> the trader is deemed to have a trading receipt equal to the market value of the disposed trading stock, notwithstanding the actual consideration received (if any). This result was thought to have operated unfairly in some circumstances, and a statement of practice was issued by the then Inland Revenue

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<sup>583</sup> TCGA 1992 s 18.

<sup>584</sup> TCGA 1992 s 286.

<sup>585</sup> (1955) 36 TC 275 (HL).

<sup>586</sup> The rule was heavily criticised by tax commentators: see eg Roger Kerridge, 'The Rule in *Sharkey v Wernher* - Time for a Reappraisal?' [2005] BTR 287 and Roger Kerridge, 'Finance Act Notes: Attempting to Enact the Rule (or "Principle") in *Sharkey v Wernher* - Section 37 and Schedule 15' [2008] BTR 439.

<sup>587</sup> Finance Act 2008, s 37 and schedule 15.

specifically excepting restaurateurs, hoteliers and others from the market value receipt rule.<sup>588</sup>

Moreover, the arm's length principle is also central to the general UK domestic transfer pricing rules.<sup>589</sup> The UK transfer pricing rules, however, have never, since their modern introduction in 1951, applied in the context of family members and their family company.<sup>590</sup> After the transfer pricing regime was extended to UK-UK transactions in 2004,<sup>591</sup> small and medium-sized enterprises were specifically exempted from its application.<sup>592</sup> As a consequence, HMRC are left to rely primarily on the 'wholly and exclusively' test and the settlements legislation (both of which are examined at length in the next Chapter) to address what Oliver and Harris recognise as essentially a transfer pricing issue.<sup>593</sup>

Notwithstanding the fact that the general UK transfer pricing rules have not been used in relation to the attribution of joint business income to the individual family members generating that income, the arm's length principle represents a useful principle for guiding how tax systems should approach this issue. But how would it apply in the

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<sup>588</sup> HM Revenue & Customs, Statement of Practice A32 (1978). Whether this concession is still available given the new statutory provisions and recent judicial criticism of concessions generally is unclear: see *R v IRC, ex parte Wilkinson* [2005] UKHL 30 [20-23] (Lord Hoffmann). Pursuant to section 160 of Finance Act 2008, the Treasury now has the power to give statutory effect to existing HMRC concessions (however described) and many ESCs were codified in 2009 by The Enactment of Extra-Statutory Concessions Order SI 2009/730. This particular concession, however, has not yet been codified.

<sup>589</sup> ITCA 1988 s 770A and Sch 28AA para 1(2).

<sup>590</sup> Oliver and Harris (n 145) 256.

<sup>591</sup> Formerly ICTA 1988 Sch 28AA para 5.

<sup>592</sup> ITCA 1988 Sch 28AA para 5B-5E.

<sup>593</sup> Oliver and Harris (n 145) 256.

context of a family business? Resort to the OECD TP Guidelines can be instructive. This is not an entirely novel approach for the UK as the UK domestic transfer pricing rules are required to be interpreted consistently with the OECD TP Guidelines,<sup>594</sup> though it would be novel in the context of intra-family dealings.

The OECD TP Guidelines provide several methods for determining arm's length prices, including the comparable uncontrolled price (CUP), resale price, cost plus, transactional net margin method and profit-split.<sup>595</sup> Which transfer pricing method is most apt in a family business situation where the profits of the business result from the unequal contributions of more than one family member? Consider the following fact pattern:

Mr and Mrs A are partners in a business providing IT services to a number of clients. Mr A, a trained and experienced IT technician, typically spends 35-40 hours per week performing IT services at clients' premises. Mrs A, who has no IT training or experience, works on average five hours per week looking after the administrative and bookkeeping side of the business. The business has no employees and little in the way of capital requirements.

One option to determine how much of the overall partnership profit should be taxed in the hands of each of Mr and Mrs A in a manner consistent with the arm's length principle is to apply the CUP method. The CUP method attempts to compare prices for services in a situation involving associated entities with prices charged between independent entities

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<sup>594</sup> ICTA 1988 Sch 28AA para 2 provides that the basic UK transfer pricing rule in para 1 shall be construed in such manner as best secures consistency with the effect of the OECD transfer pricing guidelines.

<sup>595</sup> OECD TP Guidelines (n 579) I-8.

in comparable circumstances.<sup>596</sup> For example, if a typical salary for a part-time bookkeeper and administrator providing similar services as Mrs A in the same geographical region is £10,000, this amount of profit is attributed to Mrs A and the remaining profit is attributed to Mr A.

There are several difficulties in applying the CUP approach to this fact pattern, however. First, if Mrs A is providing services at unusual hours such as answering the telephone on the weekends or in the evening, the typical part-time administrator's salary is not directly comparable; an adjustment needs to be made. Furthermore, as Mrs A is an active partner in the business she is presumably assuming unlimited liability for the debts of the business, and, consequently, the CUP needs to be priced to reflect an appropriate risk premium. If the profits of the business are low, perhaps during the start-up period or a recession, it may be that the adjusted-CUP for someone like Mrs A that reflects her 'on call' administrative support and unlimited liability would exceed the actual profits of the business (leaving none to be allocated to Mr A). On the other hand, if the children of Mr and Mrs A work for the business, performing minor clerical or cleaning duties for an hourly wage, a useful comparison may well be drawn with the amount that would be charged by an arm's length party performing similar duties. In such a situation the CUP method is an appropriate transfer pricing method.

Alternatively, a transactional profit method such as *profit split* could be used to analyse the contributions of Mr and Mrs A. Although transactional profit methods have

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<sup>596</sup> OECD TP Guidelines (n 579) G-3.

historically been considered methods of last resort,<sup>597</sup> this status appears to be changing.<sup>598</sup> The profit split method involves identifying the combined profit from a joint enterprise and then splitting that profit between participating associated entities ‘based upon an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm’s length’.<sup>599</sup> Using a contribution analysis, the combined profit is divided between associated entities based upon the *relative* value of the functions performed (taking into account assets used and risks assumed) by each of the participating associated entities, supplemented by external market data that indicate how independent enterprises would have divided profits in similar circumstances.<sup>600</sup> According to the OECD TP Guidelines, the profit split method is useful in situations where transactions are very interrelated such that independent entities would decide to set up a partnership and agree to a profit split.<sup>601</sup> As a result, the profit split method appears well suited to the family business context.

Applying a profit split method and contribution analysis to the fact pattern with Mr and Mrs A would involve analysing each of their contributions, relative to each

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<sup>597</sup> OECD TP Guidelines (n 579) [3.50].

<sup>598</sup> OECD Centre for Tax Policy and Administration, ‘Transactional Profit Methods: Discussion Draft for Public Comment’ (25 January 2008) <[http://www.oecd.org/document/53/0,3343,en\\_2649\\_33753\\_39915061\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/53/0,3343,en_2649_33753_39915061_1_1_1_1,00.html)>, accessed 22 May 2009, 6. OECD Working Party No. 6 tentatively concluded that the OECD TP Guidelines’ reference to the ‘exceptional’ use of transactional profit methods should be replaced with a greater emphasis on the relative strengths and weaknesses of each method and the importance of considering the appropriateness of methods in the particular circumstances. Where a traditional transaction method and a transaction profit method can both be applied reliably, however, the traditional transaction method (eg CUP) is generally to be preferred.

<sup>599</sup> OECD TP Guidelines (n 579) G-7.

<sup>600</sup> OECD TP Guidelines (n 579) G-3 and [3.16-.18].

<sup>601</sup> OECD TP Guidelines (n 579) [3.5].

other's contribution. A fair distribution of the profits of their joint enterprise could then be made that reflected a combination of factors, for example, taking into account the effort, skills, and financial contribution of both Mr and Mrs A, supplemented by a consideration of market data including remuneration levels for administrators and IT technicians. If both parties are assuming similar liability for the debts of the business, this does not affect their relative contributions and does not need to enter into the calculation. Assuming the administrative work was of equal value to the IT work (which could be checked against external data), the fact that Mr A works 8-10 times the hours of Mrs A on average suggests he should be entitled to a significantly higher split of the profit from their business. On these facts, a profit split of 10-15% for Mrs A and 85-90% for Mr A would satisfy the arm's length principle. As in all transfer pricing situations, there will not be one certain and unequivocal answer, but the results of a functional analysis gives a reasoned and workable result.

One advantage of applying a profit split transfer price method is its flexibility. Different attribution analyses can be made year by year, so that if one spouse takes time away from the business, for example, the distribution of profits can be adjusted accordingly to reflect the new relative contributions. Also, unlike a CUP analysis, profit split does not rely directly on closely comparable transactions. Instead, the attribution of profit is based on the division of functions between the associated parties themselves. As a result, it can take into account specific facts and circumstances that may not be present with independent entities whilst still reflecting what independent entities could have been

expected to have done in the circumstances.<sup>602</sup> This approach has the advantage of attributing to Mrs A some measure of entrepreneurial return in respect of her contribution, but one that is not tied simply to an inflexible measure such as formal share ownership, which is not easily changed from year to year. In addition, under the profit split method it is less likely that one of the parties will be left with an extreme and improbable profit result (as might obtain to Mr A under a CUP approach) since both parties are evaluated.<sup>603</sup> The OECD TP Guidelines note that a major weakness of profit split is that in the cross-border context tax authorities may have difficulty accessing the internal information necessary to check the contribution analysis.<sup>604</sup> As a result disputes between tax authorities may arise leading to unrelieved double taxation.<sup>605</sup> This is not a concern, however, in the domestic family business context.

One significant drawback to this approach, and with transfer pricing generally, is lack of certainty. Transfer pricing is not an exact science, with the result that it is perfectly possible to imagine a situation in which two similarly-situated family businesses end up with different attributions of the business profits to family members—a violation of horizontal equity. Nevertheless, transfer pricing and the arm's length principle have a long and established history as being workable in practice; tax administrators in particular are comfortable applying it. Moreover, it will be recalled from the discussion in Chapter 2 that certainty in tax law, and in law generally, is an

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<sup>602</sup> OECD TP Guidelines (n 579) [3.6].

<sup>603</sup> OECD TP Guidelines (n 579) [3.7].

<sup>604</sup> OECD TP Guidelines (n 579) [3.9].

<sup>605</sup> OECD TP Guidelines (n 579) [3.52].

important aim, but absolute certainty is neither attainable nor desirable.<sup>606</sup> Appropriate HMRC Guidance, combined with (in time) a handful of decided cases, would be able to assist taxpayers in applying the arm's length principles in a range of fact patterns.

A second significant drawback to an arm's length principle approach is the potential compliance burden imposed on small businesses in arriving at, and documenting, the application of the arm's length principle in this context. In this respect, it will be recalled that after the transfer pricing rules in ICTA 1988 Sch 28AA were broadened to include UK-UK transactions a carve-out for small and medium-sized enterprises was introduced in order to avoid imposing a large compliance burden on the kind of businesses least able to cope with such burdens. The application of the arm's length principle in this much more limited way, however, imposes a far lighter compliance burden than full compliance with UK domestic transfer pricing rules would. The calculation itself could be done at those infrequent and important times for the business and its shareholders when decisions on compensation and dividends are made, or at the time of self-assessment for income tax. In many businesses there may be little change in relative contributions year on year, which minimises the compliance burden in determining the appropriate attribution of profits—though importantly the attribution could change to reflect changes in circumstances, eg if one family member who is a shareholder decides to take an extended period of time off from the business. Contemporaneous documentation requirements could also be kept to a minimum to avoid the process becoming too burdensome.

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<sup>606</sup> See text beginning at n 98, and in particular the quotation from Fuller at n 107.

## (b) A ‘Reasonableness’ Test

An alternative to an arm’s length principle approach is to adopt a simple ‘reasonableness’ test for the attribution of jointly-produced income to the taxpayers concerned. This alternative suffers from similar concerns as the arm’s length principle method over the certainty of its application, but is less formalistic than a transfer pricing approach and may impose a lower compliance burden. It is also an approach that has been adopted internationally. For example, in the US, income splitting has not been an issue for over 50 years, primarily due to the joint spousal tax return filing option and the 1930 Supreme Court decision in *Lucas v Earl* establishing the ‘assignment of income’ doctrine, as discussed in Chapter 3.<sup>607</sup> In addition, however, in the case of non-taxable, fiscally transparent entities including partnerships and S corporations, Congress has addressed potential income shifting arrangements by adopting provisions that in certain circumstances effectively require payment of ‘reasonable compensation’ to an individual rendering services to the entity.<sup>608</sup> In a recent article comparing the UK and US approaches to income-splitting arrangements involving family businesses, Smiley and Motter cite, in this regard, Internal Revenue Code, section 704(e)(2), which provides that where a partnership interest is created by gift, the donee’s distributive share of partnership income, gain, etc shall be determined with ‘allowance of reasonable

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<sup>607</sup> Text at n 197. According to Smiley and Motter, another reason is that the interplay of employment tax rates with corporate income tax rates generally creates an incentive to distribute corporate income to shareholder-employees as salary or wages rather than as non-deductible dividends; (n 198).

<sup>608</sup> Smiley and Motter (n 198) 40.

compensation for services rendered to the partnership by the donor ...'.<sup>609</sup> The authors also cite IRC Section 1366(e), which goes even further, providing that where 'an individual who is a member of the family ... of one or more shareholders of an S corporation renders services for the corporation or furnishes capital to the corporation without receiving reasonable compensation therefor, ... such adjustments in the items taken into account by such individual and such shareholders as may be necessary in order to reflect the value of such services or capital [shall be made].'<sup>610</sup>

The Canadian tax authorities have adopted a similar legislative response to the attribution of income problem in the context of family partnerships. As the Canadian system, like the UK, uses an individual tax unit the Canadian experience is particularly instructive and will be considered at some length. The Canada Revenue Agency can challenge attempts to income-split through a family partnership by resorting to one of two quite broadly drafted legislative provisions in CITA sections 103(1) and 103(1.1). CITA section 103(1) is an anti-avoidance provision aimed at challenging agreements amongst members of a partnership (including family partnerships but also partnerships where the members are otherwise dealing with each other at arm's length) to share income in such a way as to limit tax otherwise payable:

103(1) Where the members of a partnership have agreed to share, in a specified proportion, any income or loss of the partnership from any source or from sources in a particular place, as the case may be, or any other amount in respect of any activity of the partnership that is relevant to the computation of the income or taxable income of any of the members

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<sup>609</sup> Smiley and Motter (n 198) 40.

<sup>610</sup> Smiley and Motter (n 198) 40.

thereof, and the principal reason for the agreement may reasonably be considered to be the reduction or postponement of the tax that might otherwise have been or become payable under this Act, the share of each member of the partnership in the income or loss, as the case may be, or in that other amount, is the amount that is reasonable having regard to all the circumstances including the proportions in which the members have agreed to share profits and losses of the partnership from other sources or from sources in other places.

The Canadian tax authorities successfully relied on section 103(1) in a recent Federal Court of Appeal case to thwart a loss-utilisation scheme whereby one partner was allocated a substantial portion of the income of a real estate partnership despite having little or no economic interest in the partnership because that partner had significant accumulated tax losses that could be applied to offset the income allocated to it.<sup>611</sup> It should also be noted that an alternative argument that the partnership was not a valid partnership was rejected by the Tax Court of Canada and not argued in the appeal to the Federal Court of Appeal.

CITA section 103(1.1) is even more relevant in the family income-splitting context as it is specifically aimed at income attribution in partnerships where the members are not dealing at arm's length:

103(1.1) Where two or more members of a partnership who are not dealing with each other at arm's length agree to share any income or loss of the partnership or any other amount in respect of any activity of the partnership that is relevant to the computation of the income or taxable income of those members and the share of any such member of that income, loss or other amount is not reasonable in the circumstances having regard to the capital invested in or work performed for the partnership by the members thereof or such other factors as may be relevant, that share

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<sup>611</sup> *XCO Investments Ltd et al v The Queen* 2007 DTC 5146 (FCA).

shall, notwithstanding any agreement, be deemed to be the amount that is reasonable in the circumstances.

The Canada Revenue Agency takes the position that in valuing the work performed by a partner in the activities of the partnership, both the time expended and the expertise provided are taken into consideration.<sup>612</sup> In addition, capital contributions made by a partner out of funds gifted or loans directly or indirectly from another, non-arm's length partner generally are viewed as a capital contribution of the transferor for the purpose of determining the reasonableness of the partnership income attribution, unless, in the case of loaned funds, a commercial rate of interest is charged.<sup>613</sup>

The Canadian tax authorities successfully applied section 103(1.1) in a recent case involving a husband and wife partnership. The taxpayers, Henry and Patricia Maloshicky, operated a firewood business and had for many years treated the business as an equal partnership for tax purposes. In 2003 the partnership suffered a loss, as it had for several years previously. On the advice of a new accountant, the couple allocated all of the 2003 loss to Patricia, who had other sources of income which could be sheltered by the loss whilst Henry did not. The Minister of Revenue refused the taxpayers' application to revise their allocation for the earlier years in which the business had also generated a loss, and also reassessed the taxpayers for 2003 on the basis of a 50-50 allocation of the partnership loss. The taxpayers sought judicial review of the Minister's decision, but their application was dismissed by the Harrington J of the Federal Court Trial Division.

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<sup>612</sup> Canada Revenue Agency, *Interpretation Bulletin IT-231R2* (3 March 1986) [3].

<sup>613</sup> Canada Revenue Agency, *Interpretation Bulletin IT-231R2* (n 612) [4].

Thus, the Canadian tax authorities have considerable power under these two legislative provisions to attack family income-splitting arrangements involving partnerships and arrive at their own conclusion as to the attribution of income to partnership members that is reasonable in the circumstances,<sup>614</sup> while retaining the ability to argue, in the alternative, that a partnership was not a valid partnership in the particular circumstances. CITA section 103(1.1) is particularly useful from the Canadian tax authorities' perspective when it comes to tax-motivated family income splitting arrangements as the provision allows the tax authorities to examine the work performed for the partnership, capital invested, as well as any other factors that might be relevant, in considering the appropriateness of the income distribution in the family partnership context, and does not require the authorities to establish a purpose to reduce or postpone tax as in the case under CITA section 103(1).

As the US and Canadian examples illustrate, the problem of arriving at appropriate attribution rules governing income produced through the joint efforts of two or more family members need not necessarily require complex and detailed legislation to address. As with the arm's length principle approach, however, there is some risk under a 'reasonableness' approach of horizontal inequity as profits may be distributed differently amongst family members in similar situations. Compliance costs and uncertainty remain a concern as well.

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<sup>614</sup> Section 74(4) of CITA formerly provided that remuneration received by an employee of his or her spouse's partnership was not deductible in computing the employing spouse's partnership's income and was not included in computing the income of the employee spouse. Section 74(5) formerly provided that where husband and wife were partners in business, the tax authorities could deem the income received by one spouse to be income of the other spouse. These rules were repealed in 1980 by SC 1980-81-82-83, c 48, s 40(1).

## 2. MIXED INCOME EARNED THROUGH JOINT ACTIVITY

The previous section considered the attribution of one form of income (partnership profits) earned through the joint efforts of two or more family members. This section adds a further complication—how should a tax system attribute business profits earned through the joint activity of family members where those profits represent a mixture of labour and capital income?

The appropriate response to this situation is only slightly more complicated as it involves merely a combination of the approaches to mixed income<sup>615</sup> and to joint activity already discussed. The mixed income options considered above were allowing the taxpayer to self-select the form of income (eg through a combination of salary and dividends) and the Nordic-style DIT, which imputed a return on capital and treated the remaining income as labour income. The joint activity options just considered involved an arm's length/transfer pricing approach (eg by applying the profit split method) and a 'reasonableness' test.

Consider this example (a modified version of Mr and Mrs A above):

Mr and Mrs J are equal shareholders and also employees in a company providing IT services to a number of clients. Mr J, a trained and experienced IT technician, typically spends 35-40 hours per week performing IT services at the company's clients' premises. Mrs J, who has no IT training or experience, works on average five hours per week looking after the administrative and bookkeeping side of the business. The company has no other employees and little in the way of capital requirements. The company generates a profit of £100,000 from its operations. It pays a salary of £5,000 to Mrs A and £10,00 to Mr A. After

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<sup>615</sup> Text at n 494.

payment of salaries and corporate taxes the company is left with £60,000 which it distributes equally (£30,000 each) to Mr and Mrs J as dividends. The company has little or no capital requirements.

If the tax system respects the taxpayers' self selection as to the form of their compensation, Mrs J will have capital income of £30,000 and labour income of £5,000 whilst Mr J will have capital income also of £30,000 and labour income of £10,000. A transfer pricing or reasonableness test could then be applied to test the appropriateness of the attribution of this capital and labour income to each of Mr and Mrs J. The likely conclusion would be that the attribution of profits is not consistent with arm's length principles nor is it reasonable given the nature of Mr and Mrs J's labour contribution, and most especially the difference in hours worked (capital contributed being identical and negligible).

Alternatively, under a DIT-approach, a return on capital is imputed for each (active) shareholder, which in this example is negligible. As a result, all or nearly all of the company's profits are treated as the labour income of Mr and Mrs J, to be allocated on some basis between them. This could be done using either a profit-split or reasonableness approach. The advantage of this approach is that nearly all of the income is first characterised (appropriately) as labour income and thus the taxpayers are unable to avail themselves of the more preferential treatment likely to be afforded to capital income as compared to labour income.

## **E. IMPLICATIONS FOR INCOME SPLITTING**

The analysis in this Chapter has led to the conclusion that the control model of income attribution to individual tax units is appropriate for both earned (or labour) income and unearned (or capital) income. Now that a principled basis for attributing income to tax units has been established, the issue of whether it is problematic for a taxpayer to shift income to another in order to reduce tax on that income can be considered.

Unlike many issues considered in this thesis, the answer to this one is straightforward: attempts to get around the income attribution rules by splitting or shifting income to another family member are indeed problematic. Income splitting represents a violation of the control model of income attribution. Unless income splitting is restricted, or the gains from income-shifting made less worthwhile, taxpayers will be able to self-select out of the individual tax unit and control income attribution model. This undermines the rationale for adopting the individual as the tax unit (for all the reasons discussed in Chapter 3), as well as undermining the rationale for adopting the control model (established in this Chapter). It is horizontally inequitable and economically non-neutral to allow some taxpayers to self select in this way whilst other similarly-situated taxpayers are not so allowed. It will be recalled from the Budget 2008 quote in the Introduction to this thesis that from the UK Government's perspective fairness is the primary tax policy concern in this area: 'The Government firmly believes it is unfair that some individuals can arrange their affairs to gain a tax advantage by shifting part of their income to another person who is subject to a lower rate of tax'.<sup>616</sup>

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<sup>616</sup> Text at n 5.

It also follows, however, that once income is attributed to a particular taxpayer under the attribution rules of a given tax system, then even if it formerly belonged to another or is in some way related to another taxpayer, this should not raise income-splitting concerns. It is simply applying the tax system's income attribution rules, even though it may mean less tax revenue is collected than might otherwise be the case if different attribution rules applied with the result that a different taxpayer was subject to tax on a given amount of income.

## **F. CONCLUSION**

Several important guiding principles for a tax system's approach to family income splitting arrangements emerge from the discussion in this Chapter on attribution of income to individual tax units. First, both earned (or labour) and unearned (or capital) income should be attributed to individuals on the basis of control. In the case of labour income, the employee has control over those earnings (even if they are used to benefit other family members through shared consumption) and should be taxed thereon. In addition, income arising from business activities close to the employment end of the activity spectrum can also be categorised as labour income for this purpose. Attempts to divert labour income to another, such as through an intermediary company, fall foul of this principal and need to be policed or restricted in some way.

Capital income should also be attributed to individuals on the control basis. This means that genuine transfers of effective control over capital assets between family members should be respected for attribution purposes. So long as capital income is taxed

in the hands of those with actual (not merely formal) control over the income-producing assets, then this result could not be described as giving rise to income splitting, even if the attribution of income to a particular tax unit might be different if a different income attribution model had been adopted. Conversely, transfers of less than genuine control should not be effective. Mixed capital and labour income in a system where labour and business income is taxed at different rates ideally should be dissected into a labour and a capital component, such as under the DIT approach, with income attribution rules then applied accordingly. Finally, income arising from the efforts of more than one family member should be attributed to each family member in accordance with the arm's length principle or a 'reasonableness' test, with a dissection first into its labour and capital components in the case of mixed labour and capital income. The downside is that this process will necessarily have an element of uncertainty or vagueness, and may impose significant compliance costs on small business persons who must self-assess for income tax purposes and may lack the resources to pay for professional advice. Nevertheless, to repeat an earlier quotation from Fuller: 'Sometimes the best way to achieve clarity is to take advantage of, and to incorporate into the law, common sense standards of judgment that have grown up in the ordinary life outside legislative halls.'<sup>617</sup>

The current UK rules for countering income splitting in family businesses are examined in detail, and against these guiding principles, in the next Chapter. These principles also inform the approach to reforms discussed in Chapter 6.

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<sup>617</sup> Text at n 107. See also Raz and Endicott on vagueness beginning at n 108.

# **CHAPTER FIVE: UK APPROACH TO INCOME SPLITTING IN FAMILY BUSINESSES**

## **A. INTRODUCTION**

The move to independent taxation of spouses in the UK from 6 April 1990 obviously provided an incentive for couples to arrange their affairs in such a way as to minimise their combined tax burden. Some forms of what could be loosely described as ‘income splitting’ were clearly sanctioned under the new independent regime, most particularly those involving a straightforward transfer of assets from one spouse to the other. As discussed at length in the previous Chapter, this approach is justifiable on policy grounds because it reflects the control model of attribution of capital income.

This Chapter considers how the UK tax regime currently deals with income-splitting arrangements in the context of family businesses. As will be seen, the UK tax authorities rely primarily, and not entirely successfully, on the ‘wholly and exclusively’ test and the settlements legislation. Part B begins by examining the ‘wholly and exclusively test’ and Part C discusses HMRC’s (limited) ability to challenge the validity of a family partnership. Part D—the central focus of this Chapter—analyses the settlements legislation. Part E considers the applicability of ITEPA section 447 to income-splitting arrangements. Part F concludes.

## **B. DEDUCTIBILITY OF FAMILY-RELATED BUSINESS EXPENSES**

This Part examines rules limiting the extent to which payments to family members (primarily salaries and other remuneration) are deductible in computing the profits of the family business.

## **1. BACKGROUND**

The simplest and most common method for splitting business income amongst family members is for a higher-rate taxpayer to employ his or her lower-income spouse and children in the taxpayer's business, and pay the family member salary, wages and other remuneration. This can be especially advantageous from a tax point of view if the other members of the taxpayer's family have little or no additional sources of income, as may be the case if the taxpayer's spouse stays at home to look after their children. As each family member (including each child) is entitled to a personal tax-free allowance for 2008-09 of £6035, annual salary of up to this amount can be paid without triggering any income tax in the recipient's hands.

Furthermore, NIC treatment also can be quite favourable under such arrangements as employee and employer NICs are not payable until the earnings threshold of £105 per week is reached. This means that annual salary of up to £5460 per family member can be paid free of NICs. In addition, if the salary paid exceeds the lower earnings limit of £90 per week or £4680 per year, the recipient will accrue entitlement to contributory-based national insurance benefits, even though no actual contributions have been made (all figures for 2008-09). As a result, standard tax advice is to pay family members a salary in excess of the lower earnings limit (to generate a contribution record), but below the

personal allowance and national insurance earnings thresholds.<sup>618</sup> Assuming the primary earner is in the 40% income tax bracket, this type of income splitting can be quite effective, resulting in tax and NIC savings of over £2500 per year per family member employed.<sup>619</sup> The benefits will be even greater under the new 50% top rate of income tax announced in the 2009 Budget.<sup>620</sup>

While this form of income splitting is fairly straight-forward and widely-used, the law imposes some constraints. First, remuneration arrangements involving family members may still need to satisfy minimum wage laws.<sup>621</sup> Second, where no payment is actually made by the trader in respect of the remuneration charged, Finance Act 1989 section 43 has the effect of deferring a deduction until the remuneration is paid.<sup>622</sup> Finally, and most importantly, although salaries and wages are generally a deductible expense in computing business profits, remuneration and other expenses paid to family

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<sup>618</sup> See eg Pat Joseph, Iain Watson and Hugh Williams, *101 Ways to Pay Less Tax* (Lawpack Publishing Limited, London 2005) 20.

<sup>619</sup> The income tax savings would be approximately £2000 (40% x £5000), and the NIC savings would be approximately £700 (based on a non-contracted out rate of 12.8% for the employer Class 1 NICs and 1% for the employee's Class 1 NICs contributions on the assumption that the primary earner's salary would exceed the upper earnings limit).

<sup>620</sup> See text at n 7.

<sup>621</sup> National Minimum Wage Act 1998. From 1 October 2008 the national minimum wage for adults aged 22 and over is £5.73 per hour. See also Directgov, 'The National Minimum Wage Rates' <[http://direct.gov.uk/en/Employment/Employees/Pay/DG\\_10027201](http://direct.gov.uk/en/Employment/Employees/Pay/DG_10027201)> accessed 20 April 2009.

<sup>622</sup> HM Revenue & Customs, 'Business Income Manual' <<http://www.hmrc.gov.uk/manuals/bimmanual/Index.htm>> accessed 8 June 2009, [BIM47130]. For an example of the application of this rule provision see *Abbott v Inland Revenue Commissioners* [1996] STC (SCD) 41 ('In order for Mr Abbott's claim to succeed he must show not only that services were performed by his wife, but that wages were paid to her').

members may fail to satisfy the general ‘wholly and exclusively’ test.<sup>623</sup> This test is considered next.

## 2. THE ‘WHOLLY AND EXCLUSIVELY’ TEST

Pursuant to section 34(1) of ITTOIA (applicable to unincorporated businesses) and section 54(1) of the Corporations Tax Act 2009 (for corporations, formerly section 74(1)(a) of ICTA 1988), in calculating the profits of a trade, no deduction is allowed for expenses not incurred ‘wholly and exclusively for the purposes of the trade.’ The courts have generally interpreted these words strictly. To be deductible the *sole* purpose for the expenditure must be a business purpose;<sup>624</sup> dual purpose expenditure (partly business, partly personal) generally will not be deductible.<sup>625</sup> The taxpayer’s purpose includes his or her conscious as well as unconscious purpose, but a merely incidental effect (as distinguished from another purpose) will not disqualify an otherwise deductible expense.<sup>626</sup> In the family business context, if salaries and wages are paid by the business to family members and the amount paid exceeds the amount that would be paid to an arm’s length employee providing similar services, this suggests a dual purpose to the expenditure, and the *entire* amount is non-deductible in computing the profits of the business for tax purposes. Importantly, the test has no application in the case of below-market compensation; as a result, is not a complete arm’s length principle-based solution

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<sup>623</sup> From 1915 to 1969 the deductibility of directors’ remuneration was also subject to specific legislative restrictions: see Oliver and Harris (n 145) 257-60.

<sup>624</sup> *Bentleys, Stokes & Lowless v Beeson* (1952) 33 TC 491 (CA).

<sup>625</sup> See eg *Mallalieu v Drummond* [1983] 2 AC 861 (HL), *McKnight v Sheppard* [1999] 3 All ER 491 (HL), and *Vodafone Cellular Ltd v Shaw* [1997] STC 734 (CA).

<sup>626</sup> *Mallalieu v Drummond* and *McKnight v Sheppard* (n 625). See also Tiley (n 23) 431-39.

of the kind discussed in the previous Chapter.<sup>627</sup> The test can apply to other business expenses such as rent paid for the use of a family member's personal assets (eg land).

Notwithstanding the 'all or nothing' nature of the test, in the few reported cases where courts have considered its application in the context of family business remuneration, the courts have allowed such expenditure to be split between the portion of the remuneration laid out for trading purposes (deductible) and the portion that was not. For example, in *Copeman v William Flood & Sons, Ltd*,<sup>628</sup> the taxpayer corporation carried on a pig dealing trade. The managing director's 23 year old son and 17 year old daughter were directors of the company, along with his wife and another daughter. In computing its profits for its 1938 tax year the company deducted £2,600 in directors' fees for each director. Due principally to these deductions, the company's profit for the year of just over £15,000 was turned into a loss of £300. The 17 year old daughter's duties mainly consisted of answering telephone enquiries, and the son's duties chiefly consisted of calling on farmers in order to purchase pigs. The Revenue contended that, having regard to the age and duties of the son and daughter, the salaries paid to them could not be regarded as wholly and exclusively laid out for the purposes of the company's trade. Lawrence J remitted the case to the Commissioners to find as a fact whether the sums in question were wholly and exclusively laid out for the purpose of the company's trade, and if they were not, to find how much of such sums was wholly and exclusively laid out for the purposes of the company's trade. Unfortunately, the final result is not reported,

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<sup>627</sup> See text at n 579.

<sup>628</sup> (1940) 24 TC 53 (KB).

but the key point is that the court was willing to allow a deduction for some portion of the remuneration.

Similarly, in *Stott and Ingham v Trehearne*,<sup>629</sup> a father employed his two sons in a business formerly carried on in partnership with another and paid the sons salary plus a commission equal to a percentage of the business profits. The Commissioners decided that the sums paid (amounting to 33 ⅓% of the profit each in the tax years 1918 and 1919) were disproportionate to the values of their services. The Commissioners allowed a deduction for commissions of 10% each, however, as in their view only that amount could be regarded as paid to the sons for services rendered in managing the business. This seems a harsh result in that the eldest son had assumed entire responsibility for the business during 1918 after his father's health failed. Conversely, the youngest son had been away at war all of 1918 (perhaps the Commissioners were sympathetic to the father's position that his youngest son should not be disadvantaged on account of his military service). In denying a portion of the deduction, the Commissioners may have been influenced by the fact that the accounting records of the business, as well as the correspondence between the company's accountant and the tax inspector, described the commissions as payments of a percentage of the father's profits. Rowlatt J thought that the accounts certainly were some evidence of how the parties concerned viewed the payments.<sup>630</sup> In the event, he decided not to disturb the Commissioners' findings.

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<sup>629</sup> (1924) 9 TC 69 (KB).

<sup>630</sup> *Stott and Ingham* (n 629) 75.

In *Earlsping Properties Ltd v Guest*,<sup>631</sup> Vinelott J (relying on *Copeman v Flood*) held that sums paid to the sole shareholder and director of a company was in part a ‘diversion of earnings for fiscal purposes’ from her husband’s business, and thus was not incurred wholly and exclusively for purposes of the trade.<sup>632</sup> Mrs Broomfield’s involvement in the day-to-day management of the taxpayer company was described as ‘almost entirely confined to the social side of the company’;<sup>633</sup> she performed clerical work only when necessary, such as instructing solicitors and signing leases and legal documents. The Commissioners allowed a deduction for her remuneration equal to 5% of the company’s profits. On appeal, Vinelott J stated that in his judgment, bearing in mind, among other points, the very large leap in salary from £1,000 in the 1982 accounting period to £31,488 in the 1983 accounting period and the fiscal advantages in the diversion of earned income to Mrs Broomfield, the Commissioners were entitled to conclude that the remuneration was not wholly and exclusively incurred for the purpose of the company’s business ‘but represented in part a diversion of income made to achieve a fiscal purpose’.<sup>634</sup> Indeed, Vinelott J thought it would ‘have been surprising or even perverse if the Commissioners had reached any other conclusion’.<sup>635</sup>

The ‘wholly and exclusively’ test has been applied particularly strictly when salaries and wages are paid to young children for working in the family business. For

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<sup>631</sup> (1995) 67 TC 259 (Ch).

<sup>632</sup> *Earlsping Properties* (n 631) 274.

<sup>633</sup> *Earlsping Properties* (n 631) 274.

<sup>634</sup> *Earlsping Properties* (n 631) 274.

<sup>635</sup> *Earlsping Properties* (n 631) 274.

example, in *Dollar v Lyon*,<sup>636</sup> Vinelott J affirmed the decision of the General Commissioners who had disallowed payments made by a farming couple to their three youngest children (ages 6, 8 and 10 in the tax year at issue) for work done on the family farm. Vinelott J agreed with the General Commissioners that the payments were paid as ‘pocket money’ and were not payments made wholly and exclusively for the purposes of the taxpayers’ trade within section 130(a) of ICTA 1970; however, payments made to the taxpayers’ eldest child (age 13) were allowed.<sup>637</sup> The General Commissioners took into consideration the fact that it was illegal to employ children under the age of 13 under the law as it then stood.<sup>638</sup>

Finally, it should be noted that following the rewrite of ICTA 1988 section 74 in ITTOIA section 34 and most recently in CTA 2009 section 54, the legislation now reflects the results of cases like those just discussed by expressly permitting apportionment of expenditures: if an expenditure can be dissected into parts or portions that do satisfy the sole purpose test, that part or portion will be deductible.<sup>639</sup>

### **3. CONCLUSION**

Overall, the ‘wholly and exclusively’ test imposes some limitations on the ability of family businesses to engage in income splitting through the payment of excessive remuneration to family members. The few reported cases in this context, such as *William*

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<sup>636</sup> [1981] STC 333 (Ch).

<sup>637</sup> *Dollar v Lyon* (n 636) 336.

<sup>638</sup> Then s 18 of the Children and Young Persons Act 1933 and related bylaws.

<sup>639</sup> ITTOIA s 34(2) and CTA 2009 s 54(2).

*Flood, Stott and Ingham*, and *Earlspring Properties*, have been fairly extreme income-splitting arrangements mostly involving children rather than spouses (with the exception of *Earlspring Properties*). Nevertheless, the reported cases provide an important signpost to taxpayers and their advisors that there are limits on the extent to which remuneration can be used to split business income amongst family members. The cases also demonstrate that the Commissioners and the courts are comfortable making decisions about the reasonableness of salaries and other remuneration paid to family members given appropriate (and simple) statutory authority to do so. The inherent uncertainty in applying such a broad and open-ended test is not an insurmountable hurdle to its application in practice.

A significant weakness of the test, however, is that the disallowance of the business expense is one-sided—no corresponding adjustment is made to reduce the taxable amount of the remuneration paid to the recipient, though, of course, often the recipient is not paying tax as the earnings are sheltered by the recipient’s personal allowance. In any event, and most importantly, the test cannot be a complete solution to the problem of income splitting through the payment of non-arm’s length remuneration to family members because it does not apply in situations where one family member is taking a *below-market* level of salary as part of an income-splitting arrangement with lower-income family members. The settlements provisions (discussed in detail later in this Chapter) may apply in such cases, however. A more robust transfer pricing rule or a reasonableness test of compensation (as considered in the previous Chapter) is preferable in this regard because either approach could address both over- and under-compensation of family members. If a transfer pricing approach were chosen, the CUP method (which

attempts to compare prices for services in a situation involving associated entities with prices charged between independent entities in comparable circumstances) seems to be particularly well suited to situations involving remuneration paid to spouses or children making limited contributions to the business. In such fact patterns the absolute value of the remuneration paid can be usefully compared with amounts that would be paid instead to an arm's length party providing similar services.<sup>640</sup>

### **C. VALIDITY OF A FAMILY PARTNERSHIP**

Another simple way to split business income amongst family members is to carry on the business through a family partnership. Partnerships are not assessed to tax; rather, a partner's share of a profit or loss of a trade carried on by a partnership is determined for income tax purposes in accordance with the partnership's profit-sharing arrangements during that period.<sup>641</sup> If a low- or no-income spouse is taken into partnership in a business formerly carried on as a sole proprietorship by a high-income spouse, for example, the profits of the business can be allocated to both partners, thus allowing the low-or no-income partner to make use of his or her personal allowance and basic rate tax band. The result will be less combined tax for the spouses. Importantly, HMRC cannot challenge the apportionment of profits to partners as they can the payment of a salary to a spouse under the 'wholly and exclusively' test just described.<sup>642</sup> Moreover, there is no requirement for the spouse to contribute capital or to participate in management or even

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<sup>640</sup> See text at n 596.

<sup>641</sup> ITTOIA s 850(1), formerly ICTA 1988 s 111(3).

<sup>642</sup> HM Revenue & Customs, Business Income Manual (n 622) [BIM72065].

to take an active part in the business.<sup>643</sup> The one caveat is the partnership must be valid, ie meet the requirements for the existence of a partnership.

The Partnership Act 1890 defines a partnership as ‘the relation which subsists between persons carrying on a business in common with a view of profit’.<sup>644</sup> These requirements will generally be easily satisfied in the case of adult partners.<sup>645</sup> Partnerships between parents and their minor children, however, are less likely to satisfy the requirements because the courts are reluctant to believe that minor children are capable of being genuine business partners, even if they are named as such in the partnership deed.<sup>646</sup> For example, in *Alexander Bulloch & Co v Commissioners of Inland Revenue*,<sup>647</sup> two minor children (aged 15 and 16) were alleged to be partners in the family wine and spirits off-license shops. Both children worked at one of the shops but neither drew their share of the partnership profits. A partnership deed had been drawn up two years after the year at issue, but purporting to apply retroactively to that year. The General Commissions decided on the facts before them, and particularly ‘the inexperience and immaturity’ of the minor children (who gave evidence), that the

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<sup>643</sup> HM Revenue & Customs, Business Income Manual (n 622) [BIM72065]; Sir Andrew Park and others (eds), *Simon’s Taxes* (LexisNexisButterworths, London 2009) [B7.202].

<sup>644</sup> Partnership Act 1890 s 1(1).

<sup>645</sup> HM Revenue & Customs, Business Income Manual (n 622) [BIM72065]: ‘Where the spouse has signed a deed declaring an intention to carry on the business and the deed gives a right to share in the profits, and subsequently accounts of the business show that that person has been allocated a share of the profits, there will not usually be much chance of mounting a successful challenge’.

<sup>646</sup> Sarah Deek (ed), *Tolley’s Tax Essentials: Family Taxation* (Tolley LexisNexis, London 2003) 106; Park (n 643) [B7.102]. In some businesses such as farming HMRC may be more likely to accept that a minor children could be an active partner: see HM Revenue & Customs, Business Income Manual (n 622) [BIM72065].

<sup>647</sup> [1976] 51 TC 563 (Ct Sess).

children were not partners in the relevant year; the Court of Session chose not to interfere with the Commissioners' conclusion.<sup>648</sup>

In summary, the requirements for a valid partnership are too easily satisfied and too blunt an instrument to be particularly effective at policing income splitting through a family partnership. This test will catch only the most egregious cases, such as those involving minor children. As with the 'wholly and exclusively' test, a transfer pricing solution grounded in the arm's length principle or a reasonableness test is more flexible and more effective. If a transfer pricing solution were adopted, a transactional profit method such as profit split could take into consideration the relative contributions of all family partners and thus appears to be more appropriate than the CUP method.<sup>649</sup> Attempts to income split through family partnerships (and companies) may fall foul of other restrictions, however, most importantly the settlements provisions. These rules are discussed next.

#### **D. THE SETTLEMENTS LEGISLATION**

Another common method for splitting the profits of an incorporated family business amongst family members is to pay them dividends. Although salaries and other forms of remuneration are generally deductible in computing the taxable income of the business, dividends are not; they are paid from the company's after-tax profits. Until recently, earnings distributed by way of dividends may have been subject to a UK corporate tax

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<sup>648</sup> *Alexander Bulloch & Co v Commissioners of Inland Revenue* (n 647) 563.

<sup>649</sup> See discussion of profit split at n 597.

rate as low as 0%.<sup>650</sup> Prior to 2008, companies generally were subject to corporate tax at a rate of 19% (the small companies' rate) on profits up to £300,000, rising to 30% on profits over £1,500,000.<sup>651</sup> The Government announced in the 2007 Budget, the small companies' rate would increase to 22% and the 30% corporate tax rate drop to 28% from April 2008.<sup>652</sup> In response to the economic downturn the Government froze the small companies' rate at 21% for 2009-10.<sup>653</sup>

The fact that dividends are paid out of after-tax corporate profits and thus subject to a tax rate of at least 21% may make the payment of dividends to family members less attractive than salary payments as an income-splitting device. Dividends have some important advantages, however; for one, dividends are not subject to employee or employer NICs, which together can account for an extra 23 per cent charge over and above any income tax liability. In addition, the personal tax of 10% payable on corporate dividends is cancelled out by a non-refundable credit for lower- and basic-rate taxpayers as well as non-taxpayers. Business profits distributed to these taxpayers will suffer only the corporate tax. Higher-rate taxpayers pay an additional amount of tax, equal to 25% of the cash dividend.<sup>654</sup>

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<sup>650</sup> For a discussion of the UK's failed experiment with a nil starting rate for corporate profits (introduced in 2002 and removed in the 2005 Pre-Budget Report) see Judith Freedman, 'Why Taxing The Micro-Business Is Not Simple- A Cautionary Tale From The "Old World"' (paper presented at the Australasian Tax Teachers Association Annual Conference 2006) <<http://www.law.unimelb.edu.au/taxgroup/JudithFreedman.pdf>> accessed 15 June 2009, 16-20.

<sup>651</sup> FA 2005 ss 10-11.

<sup>652</sup> HM Treasury, '2007 Budget' (HC 342, 2007) [3.23].

<sup>653</sup> HM Treasury, '2009 Budget' (n 7) [4.10].

<sup>654</sup> ITA 2007 ss 8, 13, 19, 23 formerly ICTA 1988 s 1B.

As will be shown, this fairly simple income-splitting device of paying dividends to family members (sometimes called ‘dividend sprinkling’) raises a number of difficult legal issues. Since dividends are paid after-tax, the ‘wholly and exclusively’ deductibility test discussed earlier in this Chapter is not applicable. The settlements provisions, however, may restrict a family’s ability to split business profits in this way.

## 1. THE PROVISIONS

The settlements provisions formerly found in Part XV of ICTA 1988 and, from 6 April 2005, rewritten as Part 5 Chapter 5 of ITTOIA have been around in various guises since the 1930s. These provisions are anti-avoidance legislation designed to prevent an individual from gaining a tax advantage by making arrangements to avoid tax in various ways including by accumulating income or splitting his or her income with other persons who are taxed at a lower rate or are not liable to income tax at all.<sup>655</sup> Typically, the provisions apply where an individual seeks to divert income to family members (particularly to a spouse and/or minor children) through a trust. A second primary aim of the settlements provision was to restrict the use of entities such as trusts as ‘piggy banks’ where income is taxed at the entity’s tax rate rather than the settlor’s (higher) marginal rate; this has become less of a concern following the alignment in 2004 of the rate applicable to trusts and dividend trust rate with the top rates for individuals.<sup>656</sup>

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<sup>655</sup> Peter Whiteman and others, *Whiteman on Income Tax* (3<sup>rd</sup> edn Sweet & Maxwell, London 1988) 994-95. A similar description can be found in Tax Law Rewrite Committee, ‘Settlements’ Paper CC(03)(16) (2003) [2]. The provisions also target alienation of income to non-residents, but that aspect is beyond the scope of this thesis.

<sup>656</sup> ITA 2007 ss 9, 479, 481 formerly ICTA 1988 ss 686(1)-(1A) as amended by FA 2004 s 29.

It should be noted that until recently provisions similar to the settlements provisions also applied for capital gains tax purposes; however, these provisions were no longer necessary when the flat 18% rate of capital gains tax was introduced in 2008 and were repealed.<sup>657</sup> As briefly mentioned earlier, the settlements provisions also potentially apply to excessive salaries paid to family members, or at least HMRC takes the position that they do. For example, the HMRC Business Income Manual states: ‘Where remuneration that cannot be justified on ordinary commercial grounds is paid to a director/employee who is the husband, wife or minor child of the controlling shareholder(s) or director(s), liability to tax may also arise under the settlements legislation...’<sup>658</sup> Similarly, HMRC’s position is that where one spouse takes the other into partnership with a share of profits but with no requirement, or insufficient requirement, to contribute capital and/or personal time and effort the settlements provisions can apply.<sup>659</sup> The settlements provisions thus represent the broadest and, potentially, most powerful weapon in HMRC’s arsenal in its fight against income splitting in the family business context. Their legislative history is considered next.

#### (a) History

Until the early 1920s there is little evidence that income-splitting arrangements involving settlements were prevalent or of any great concern to the Revenue, probably because the

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<sup>657</sup> Formerly TCGA 1992 ss 77-79, repealed by FA 2008 Sch 2 s 5.

<sup>658</sup> HM Revenue & Customs, Business Income Manual (n 622) [BIM47105].

<sup>659</sup> Settlements Guide (n 2) [4.6] and Examples 20 and 21.

rates of income tax were so low that very little tax saving could be realised.<sup>660</sup> In Finance Act 1922, an attempt was made to curtail a rise in such schemes, especially those involving dispositions to minor children otherwise than by outright gift, in response to significant increases during the war years in tax rates and the number of individuals subject to income tax.<sup>661</sup> The arrangements targeted in Finance Act 1922 section 20 were limited to (a) settlor-revocable dispositions, (b) dispositions for short periods, or (c) dispositions by a parent in favour of a child for a period less than the life of the child. If a disposition fell into one of these three categories, section 20 deemed the income (whether distributed or not) to be that of the person who made the disposition, but in the case of a (c)-type disposition only for so long as the child was an infant and unmarried.<sup>662</sup> The term ‘disposition’ was defined to include any trust, covenant, agreement or arrangement.<sup>663</sup>

The creativity of taxpayers and their advisors in structuring dispositions that fell outside these limited categories shortly rendered the 1922 provision ‘almost worthless’ in reducing the avoidance to which it was aimed.<sup>664</sup> Thus began a running battle between advisors and the Revenue in this area, which led next to the enactment in Finance Act 1936 of new provisions aimed at a broader range of parental settlements on their minor

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<sup>660</sup> David P Stopforth, ‘The Background to the Anti-avoidance Provisions Concerning Settlements by Parents on Their Minor Children’ [1987] BTR 417, 418; Oliver and Harris (n 145) 246-48.

<sup>661</sup> Stopforth (n 660) 419 and David P Stopforth, ‘Settlements and the Avoidance of Tax on Income - The Period to 1920’ [1990] BTR 225, 236-37.

<sup>662</sup> FA 1922 s 20. For background on the enactment of the 1922 provisions see David P Stopforth, ‘The First Attack on Settlements Used for Income Tax Avoidance’ [1991] BTR 86.

<sup>663</sup> FA 1922 s 20(5).

<sup>664</sup> Stopforth (n 660) 423.

children.<sup>665</sup> Under the 1936 rules, where by virtue or in consequence of a settlement income was *paid* to or for the benefit of a child of the settlor who was an infant and unmarried, the income was deemed to be income of the settlor and not the income of any other person.<sup>666</sup> The 1936 provisions focus on ‘settlements’ rather than the ‘dispositions’ targeted in the 1922 legislation. The terms overlap to a large extent, however, as ‘settlement’ was defined to include ‘any disposition’ as well as ‘trust, covenant, agreement, [or] arrangement’, which terms had comprised the 1922 definition of ‘disposition’; the phrase ‘transfer of assets’ was a new addition.<sup>667</sup> Certain settlements were exempted, including irrevocable settlements created pre-Budget,<sup>668</sup> and a de minimus exemption applied where the income in the year of assessment did not exceed five pounds.<sup>669</sup>

A mere two years later, additional legislation was passed in Finance Act 1938 to target a different evil, namely ‘piggy bank’ settlements aimed at reducing liability for surtax (other than the kinds of parental settlements on minor children already caught by the 1936 provisions).<sup>670</sup> The principle underpinning the Revenue’s proposals leading to the 1938 rules was that if an individual had not parted with his wealth beyond recall, he

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<sup>665</sup> Board of Inland Revenue, ‘Finance Bill, 1936: Notes on Clauses’ Clause 19, 51-67. The Finance Bill notes included examples of the ‘enormous numbers’ of deeds made ‘by all classes of taxpayers to reduce their tax liability’, with schemes ‘actually being hawked round from door to door by insurance agents and other touts’: 53. For additional background on the enactment of the 1936 provisions see David Stopforth, ‘The Pre-Legislative Battle over Parental Settlements on Their Children’ [1994] BTR 234.

<sup>666</sup> FA 1936 s 21.

<sup>667</sup> FA 1936 s 21(9)(b).

<sup>668</sup> FA 1936 s 21(10).

<sup>669</sup> FA 1936 s 21(4).

<sup>670</sup> For background on the enactment of the 1938 provisions see David Stopforth, ‘The Legacy of the 1938 Attack on Settlements’ [1997] BTR 276.

should be treated as still owning it for income tax and surtax purposes.<sup>671</sup> The new provisions were aimed primarily at revocable settlements and irrevocable annual payments, which were being used as savings boxes for settlors to deposit annual sums that were deductible in computing the surtax liability of the settlor.<sup>672</sup> Irrevocable settlements where the settlor was able to enjoy in effect the income of the settlement by means of loans from the trustees were also targeted by deeming the capital sum (or a portion thereof) to be income of the settlor.<sup>673</sup> Crucially for present purposes, irrevocable settlements in which the settlor retained an interest would also be caught.<sup>674</sup> At the time the Revenue believed that the most serious avoidance involved settlements that could be revoked with the consent of someone other than the settlor or his spouse; less attention was paid to settlor-interested settlements.<sup>675</sup> Indeed, the initial memorandum from the Revenue to the Chancellor in February 1938 on the new proposals did not even discuss the fact that settlor-interested settlements would be caught; this point was mentioned only in a covering note.<sup>676</sup> The Chancellor picked up on the point and while satisfied that a settlor retaining an interest in an irrevocable settlement should be caught, he insisted that in such a case the provisions would apply only to accumulated income.<sup>677</sup>

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<sup>671</sup> Stopforth (n 670) 278.

<sup>672</sup> Board of Inland Revenue, 'Finance Bill, 1938: Notes on Clauses' Clause 33, 108-10.

<sup>673</sup> Board of Inland Revenue, 'Finance Bill, 1938: Notes on Clauses' Clause 34, 111-13.

<sup>674</sup> Board of Inland Revenue, 'Finance Bill, 1938: Notes on Clauses' Clause 32, 99-107. The Finance Bill notes included an example of 'a particular form of deed which was alleged to be rapidly coming into almost universal use under which it was possible for Surtax payers to reduce their Surtax liability at the cost of a 10s deed stamp': 101. See also Stopforth (n 670) 278.

<sup>675</sup> Stopforth (n 670) 278-79.

<sup>676</sup> Stopforth (n 670) 279.

<sup>677</sup> Stopforth (n 670) 279.

The settlor-interested rules ultimately introduced in Finance Act 1938 provided that where the settlor retained an interest in any income arising under or property comprised in a settlement, any income so arising during the life of the settlor, to the extent it was not distributed, was to be treated as the income of the settlor and not as the income of any other person for income tax purposes.<sup>678</sup> Furthermore, a settlor was deemed to have an interest in income arising under or property comprised in a settlement if any income or property which may at any time arise under or be comprised in the settlement is, or will or may become, payable to or applicable for the benefit of the settlor or the wife or husband of the settlor in any circumstances whatsoever.<sup>679</sup> Certain narrow exceptions were provided, eg if the income or property was payable to the settlor or the settlor's spouse in the event of the bankruptcy of another who was or may become beneficially entitled to the property; nevertheless, the rules applicable to settlor-interested settlements were broadly drafted.

Further minor changes to these settlements provisions were made in subsequent years, but the substance of the 1936 and 1938 rules relevant for this thesis remained intact. The settlements on children rules eventually became sections 663-670 of ICTA 1988 and the settlor-interested provisions became section 673. The next significant amendment occurred as a result of the move to independent taxation of husband and wife in 1988. Freedman and Schuz noted at the time that some interested parties, especially the Law Society's Revenue Law Committee on the Finance (No. 2) Bill 1988, had expressed

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<sup>678</sup> FA 1938 s 38(3).

<sup>679</sup> FA 1938 s 38(4).

concern that outright gifts between spouses might constitute a settlement.<sup>680</sup> These concerns led to clause 109 of Finance Bill 1989, which introduced an exemption from the settlements provisions for gifts between spouses that eventually became ICTA 1988 section 660A(6). The exemption was intended to be consistent with the general objectives of independent taxation by ensuring that income arising from the gift of an asset between husband and wife was taxed in the hands of the recipient and not the spouse making the gift so long as it was an unconditional gift of both the asset and the income arising from it.<sup>681</sup> This exemption accords with the ownership/control model for the attribution of capital income of spouses discussed in Chapter 4.<sup>682</sup> At the time, there was no mention in the debates or in the accompanying Inland Revenue press release of how, if at all, this exemption was meant to operate in the context of family businesses.<sup>683</sup>

Furthermore, as Redston argues, the Hansard debates on clause 109 make it clear that the Government understood that there would be tax avoidance as a result of the exemption for outright gifts, but that it accepted this as a necessary consequence of independent taxation.<sup>684</sup> This is evident from the Government's reaction to an amendment put forth by the Labour Party (later withdrawn) to deny the exemption if 'the gift was undertaken with the sole or main objective of achieving a tax advantage'.<sup>685</sup> The Financial Secretary to the Treasury (Norman Lamont) criticised the proposed amendment

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<sup>680</sup> Freedman and Schuz (n 80) 205.

<sup>681</sup> Inland Revenue budget press release (14 March 1989), reproduced in [1989] BTR 559.

<sup>682</sup> See text beginning at n 525.

<sup>683</sup> Anne Redston, 'Unsettled Business' (13 November 2003) 152 *Taxation* 162.

<sup>684</sup> Redston (n 683).

<sup>685</sup> Discussed in Standing Committee G (13 June 1989): see Redston (n 683) and Redston (n 62) 682.

for undermining independent taxation, and went so far as to say that '[i]ndependent taxation is bound to mean that some couples will transfer assets between them with the result that their total tax bill will be reduced. This is an inevitable and acceptable consequence of taxing husbands and wives separately'.<sup>686</sup> Freedman and Schuz pointed out that this approach favours those couples who have investment income over those who have earned income and cannot transfer the source of the income.<sup>687</sup> For the reasons discussed in Chapter 4, however, this is an argument grounded in vertical equity not horizontal equity, which, whilst attractive, must also be balanced against other arguments, including those supporting favourable taxation of capital income and the control model of capital income attribution.<sup>688</sup> Finally, Freedman and Schuz went on to note, presciently, that the provisions as drafted raised questions as to what is an outright gift.<sup>689</sup>

Whiteman commented on the state of the entirety of the settlements provisions in 1988, stating that although collected together in Part XV of ICTA 1988, the provisions did not form a comprehensive code, they were not co-ordinated, frequently they overlapped, and for many types of settlement reference to several provisions was necessary.<sup>690</sup> The situation was improved in 1995 when the provisions were comprehensively rewritten and simplified. The settlements on children rules were

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<sup>686</sup> Standing Committee G (13 June 1989). Similar statements were made a year earlier: see Standing Committee A (23 June 1988) col. 624.

<sup>687</sup> Freedman and Schuz (n 80) 205.

<sup>688</sup> See in particular discussion at n 438, n 461 and n 524.

<sup>689</sup> Freedman and Schuz (n 80) 210.

<sup>690</sup> Whiteman (n 655) 994-95.

rewritten as section 660B of ICTA 1988<sup>691</sup> and the settlor-interested provisions became section 660A.<sup>692</sup> The settlements provisions were again rewritten in ITTOIA, though the resulting changes were minor and cosmetic in nature, with much of the previous wording repeated.

It is clear from this review of the legislative history that the settlements provisions were not intended to deal with income-splitting arrangements involving family businesses.<sup>693</sup> The settlements provisions as they now read are discussed next.

## (b) Current Provisions

The current version of the settlements provisions relevant for this thesis are found principally in ITTOIA sections 620-629 (formerly ICTA 1988 sections 660A- 660G), and are fairly brief. Section 620 sets out the key definitions:

620(1) In this Chapter –

“settlement” includes any disposition, trust, covenant, arrangement or transfer of assets...

“settlor”, in relation to a settlement, means any person by whom the settlement was made.

(2) A person is treated for the purposes of this Chapter as having made a settlement if the person has made or entered into the settlement directly or indirectly.

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<sup>691</sup> Inserted by FA 1995 s 74 Sch 17 para 1.

<sup>692</sup> Inserted by FA 1995 s 74 Sch 17 para 1.

<sup>693</sup> Oliver and Harris arrive at the same conclusion: (n 145) 251.

(3) A person is, in particular, treated as having made a settlement if the person (a) has provided funds directly or indirectly for the purpose of the settlement, (b) has undertaken to provide funds directly or indirectly for the purpose of the settlement, or (c) has made a reciprocal arrangement with another person for the other person to make or enter into the settlement.

The current definitions are nearly identical to those introduced in the 1936 parental settlement provisions.<sup>694</sup> Section 624 is the main charging provision; its ambit is extended by section 625:

624(1) Income which arises under a settlement is treated for income tax purposes as the income of the settlor and of the settlor alone if it arises (a) during the life of the settlor, and (b) from property in which the settlor has an interest.

625(1) A settlor is treated for the purposes of section 624 as having an interest in property if there are any circumstances in which the property or any related property (a) is payable to the settlor or the settlor's spouse, (b) is applicable for the benefit of the settlor or the settlor's spouse, or (c) will, or may, become so payable or applicable.

...

(5) In this section "related property", in relation to any property, means income from that property or any other property directly or indirectly representing proceeds of, or of income from, that property or income from it.

Section 626 provides the exemption for 'outright gifts' between spouses formerly found in ICTA 1988 section 660A(6):

626(1) The rule in section 624(1) does not apply in respect of an outright gift (a) of property from which income arises, (b) made by one spouse to the other, and (c) meeting conditions A and B.

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<sup>694</sup> Text at n 666.

(2) Condition A is that the gift carries a right to the whole of the income.

(3) Condition B is that the property is not wholly or substantially a right to income.

(4) A gift is not an outright gift for the purposes of this section if (a) it is subject to conditions, or (b) there are any circumstances in which the property, or any related property (i) is payable to the giver, (ii) is applicable for the benefit of the giver, or (iii) will, or may become, so payable or applicable.

(5) "Related property" has the same meaning in this section as in section 625.

Finally, the main provision governing settlements and unmarried minor children is section 629, which states:

629(1) Income which arises under a settlement is treated for income tax purposes as the income of the settlor and of the settlor alone for a tax year if, in that year and during the life of the settlor, it (a) is paid to, or for the benefit of, an unmarried minor child of the settlor, or (b) would otherwise be treated (apart from this section) as income of an unmarried minor child of the settlor.

(2) Subsection (1) does not apply to income which is treated as income of the settlor under section 624.

(3) Subsection (1) does not apply in relation to a child's relevant settlement income in any tax year if, in that year, the total amount of that income does not exceed £100.

(4) In subsection (3) a child's "relevant settlement income" means income (a) which is paid to or for the benefit of, or otherwise treated as income of, the child, and (b) which (apart from subsection (3)) would be treated as income of the settlor under subsection (1).

A child under 18 years of age is a minor.<sup>695</sup> Section 629 also applies to stepchildren of the settlor<sup>696</sup> and, since 2005, does not apply if the minor has entered into a civil partnership. The key difference in the application of the settlements provisions to settlements in favour of spouses and those in favour of minor children is that there is no ‘outright gift’ exclusion in the case of minor children; indeed it has been held that absolute gifts of funds from a father into post office savings bank accounts in the name of his minor children were caught by the settlements provisions.<sup>697</sup> As a result, in contrast to the situation involving spouses, the application of the settlements provisions is more straightforward, and more strict, when minor children are involved.<sup>698</sup>

In summary, the settlements provisions operate to deem one person’s income (a spouse’s income, an unmarried minor child’s income) as another’s (the settlor’s). Two points should be noted at this stage. First, the wording is quite broad – especially the definition of ‘settlement’ in section 620 – reflecting the anti-avoidance purpose of the provisions. Second, the inclusion of the words ‘or the settlor’s spouse’ in section 625(1) means that a settlor is automatically deemed to have an interest in his or her spouse’s property and related property, which includes income from the property such as dividends on the spouse’s shares in the family company. If the settlor has such an interest, the settlor will be taxable on income arising from the settlement under section 624(1) unless the spousal ‘outright gift’ exception in section 626(1) applies. As discussed

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<sup>695</sup> ITTOIA s 629(7)(b).

<sup>696</sup> ITTOIA s 629(7)(a).

<sup>697</sup> *Thomas v Marshall* [1953] AC 543 (HL).

<sup>698</sup> For a historical overview of the settlements legislation as applied to minor children up to 1982 see Brice (n 154) 260-64.

in Chapter 3, although the UK has adopted the individual as tax unit for income and capital gains tax purposes, in many cases the taxpayer's marital status will have some bearing on his or her tax situation.<sup>699</sup> This is particularly the case with anti-avoidance provisions (like the settlements provisions) the scope of which are extended to include spouses in order to stop an otherwise obvious and easy way to circumvent the measures in question.

Finally, the application of the settlements provisions is not limited to settlements diverting income to spouses or minor children; a settlement in favour of a parent, sibling, adult child, friend, boyfriend/girlfriend, or unmarried cohabitating partner potentially is caught by these rules so long as the settlor or the settlor's spouse has an *actual* interest in the settlement property or related property. Because the legislation deems spouses to have such an interest (whether in fact they do or not), the legislation bears more heavily on married couples and registered civil partners than on others. This no doubt reflects an underlying assumption (and probably a good one) that it is in these relationships that the risk of purely tax-driven income splitting is highest, as well as the fact that an exception applies to outright gifts between spouses. Nevertheless, there seems no reason in principle why only married spouses should be treated in this manner. If instead one applied the relationship-neutral functionality test recommended by the Law Commission of Canada (discussed in Chapter 3)<sup>700</sup> in principle the rules applicable to spouses could be extended to other relationships such as cohabiting couples living together as man and wife. Extending the rules in this way is consistent with other recently-introduced anti-

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<sup>699</sup> Text beginning at n 323.

<sup>700</sup> See text beginning at n 332.

avoidance rules, including the managed service company rules aimed at addressing tax-motivated attempts to disguise employment through the use of intermediaries.<sup>701</sup>

## **2. THE REVENUE'S POSITION ON SETTLEMENTS AND FAMILY BUSINESSES**

In November 2004 the Inland Revenue published a guide on the settlements provisions and their application in the small business context.<sup>702</sup> In the Settlements Guide, the Revenue stated that in their view the settlements provisions can apply in the context of family businesses even when a trust is not involved.<sup>703</sup> The Revenue cited as an example a husband and wife that were equal shareholders in a small IT consulting company, with the husband responsible for earning the fees while the wife acted as company secretary but otherwise made no contribution to the business. If the income arising from the business was paid out equally between them as dividends, the Revenue took the position that the settlements provisions would apply and the dividends paid to the wife would be taxed as her husband's income.<sup>704</sup> In the particular case of companies, the Revenue listed a number of questions to be asked in determining whether the settlements legislation can apply.<sup>705</sup>

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<sup>701</sup> It will be recalled that for purposes of the managed services company rules, 'a man and a woman living together as husband and wife are treated as if they were married to each other': see text at n 247.

<sup>702</sup> Settlements Guide (n 2). The Settlements Guide incorporates and expands upon previous guidance published in Inland Revenue Tax Bulletin 64 (April 2003) and Tax Bulletin 69 (February 2004) <<http://www.hmrc.gov.uk/bulletins/>> accessed 16 April 2006.

<sup>703</sup> Settlements Guide (n 2) [2.2].

<sup>704</sup> Settlements Guide (n 2) Annex A, example 11.

<sup>705</sup> Settlements Guide (n 2) [4.3].

- What has been invested?
  
- What assets, trade, profession have been placed in the company and by whom?
  
- Who does what to earn the income of the company?
  
- Is the remuneration paid at a commercial rate for the job?
  
- Is someone getting a disproportionate return on the capital they have invested because of their relationship with the settlor?

The Revenue took the view that a good general test of whether or not the settlements provisions apply in a business context is to consider whether the payments at issue (eg dividend payments) would be made to a person who acquired shares in the company at arm's length.<sup>706</sup> The Revenue's position was that in deciding whether an individual is drawing an uncommercial (low) salary, it was necessary to look at the going rate for the job and also the individual's previous earnings.<sup>707</sup> In determining whether someone is receiving a disproportionate return on capital investment, the Revenue stated that it is necessary to look at the return on the actual capital invested and also any risks.<sup>708</sup> By way of example, the Revenue viewed someone who invests £1 in an ordinary share and gets £35,000 a year in dividends as earning a disproportionate return since that £1 invested in

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<sup>706</sup> Settlements Guide (n 2) [2.1].

<sup>707</sup> Settlements Guide (n 2) [4.9.1].

<sup>708</sup> Settlements Guide (n 2) [4.8.1].

the stock market or a bank would have generated a much lower return.<sup>709</sup> This position is understandable and justifiable in principle—as discussed in Chapter 4, in attempting to allocate the joint product of the combined efforts of two or more family members an application of the arm’s length principle is a suitable approach.<sup>710</sup> The difficulty for the Revenue, however, is there is no explicit reference to the arm’s length principle in the settlements legislation providing the authority for such an approach.

While the Revenue asserted that their position has been in place since the early 1990s, their pronouncements were met with considerable surprise and opposition from the tax community.<sup>711</sup> Organisations including the CIOT and the Tax Faculty of the Institute of Chartered Accountants of England and Wales took the somewhat unusual step of banding together to challenge the appropriateness of applying the settlements provisions to what had been regarded as long established, even government-sanctioned, family business structures.<sup>712</sup> The debate quickly moved into the courtroom; the cases on settlements and the family businesses are examined next.

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<sup>709</sup> Settlements Guide (n 2) [4.8.1].

<sup>710</sup> Text at n 579.

<sup>711</sup> Francesca Lagerberg, ‘Why We Should Not Settle for This’ (29 April 2004) 153 *Taxation* 105 (‘Members of the working party have been trying to obtain better information and guidance from the Revenue since the April 2003 Tax Bulletin was launched on a largely unsuspecting world’); Anne Redston, ‘The Settlement Saga’ (25 November 2004) 154 *Taxation* 202 (‘Act 1: The Revenue launches surprise attack on small businesses. Act 2: The professional bodies mount massed counter-attack’.).

<sup>712</sup> Tax Faculty of the Institute of Chartered Accountants in England and Wales and others, ‘Section 660A, ICTA 1988: Tax, Small Businesses and the Settlements Legislation – Commentary on Tax Bulletin Article’ (September 2003) *Taxrep* 32/03 and ICAEW and others, ‘Second Joint Letter to the Inland Revenue Concerning the Settlements Legislation and Small Business’ (November 2003) *Taxrep* 42/03  
<[http://www.icaew.co.uk/library/index.cfm?AUB=TB21\\_56684%7CMNXI\\_56684](http://www.icaew.co.uk/library/index.cfm?AUB=TB21_56684%7CMNXI_56684)> accessed 16 April 2006. See also Redston (n 683) (‘It is not uncommon for individual tax specialists to be at

### 3. CASE LAW ON SETTLEMENTS AND FAMILY BUSINESSES

The analysis in this section is primarily doctrinal and centres on the key definitions in the settlements provisions. The leading authority is now the 2007 House of Lords decision in *Jones v Garnett*<sup>713</sup> (also known as the Arctic Systems case, after the name of the taxpayer's company). The case concerned dividends paid to a husband and wife from a company they jointly owed, but the provisions at issue potentially apply to a much broader range of family income-splitting arrangements, including partnerships. HMRC was successful before the Special Commissioners (by casting vote) and in the High Court, but a unanimous Court of Appeal found for the taxpayer, Mr Jones. On appeal to the House of Lords, the taxpayer was ultimately victorious, with all five of the Law Lords finding for Mr Jones, albeit for different reasons than the Court of Appeal.

As Lord Neuberger helpfully explained, the difficulty arising from the two issues in the case—was there a settlement, and, if so, did the spousal outright gift exception apply—is well illustrated by the difference of judicial opinion in the case:<sup>714</sup>

‘The senior special commissioner found for the Revenue on both issues; the junior commissioner found against the Revenue on both issues. Park J found for the Revenue on both issues but his main reason on the second one was different from that of the senior commissioner. The Court of Appeal found against the Revenue on the first issue, but would have been for the Revenue on the second issue, although disagreeing with the reason of the senior commissioner. Your Lordships agree with the Revenue on the first issue, but are against them on the second.’

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odds with Inspectors, but the almost unanimous rejection of the Revenue's legislative interpretation by so many tax professionals is unprecedented.’)

<sup>713</sup> [2005] EWHC 849 (Ch) (*Jones* (HC)), rev'd [2005] EWCA Civ 1553 (*Jones* (CA)), aff'd [2007] UKHL 35 (*Jones* (HL)).

<sup>714</sup> *Jones* (HL) (n 713) [74].

The facts of the *Jones v Garnett* case are relatively straightforward and are set out here at some length because the case is of critical importance to the analysis that follows, and also because the case provide a textbook example of the kind of family income-splitting arrangements with which this thesis is concerned. Mr Jones had been an employee in the information technology field for a number of years. When he was made redundant in 1992, he and his wife (a former catering manager) decided to start an information technology consulting business. Information technology agencies and their clients would deal only with limited companies, not unincorporated self-employed consultants, presumably to avoid possible arguments that the consultant was in fact an employee, which would trigger employment law and payroll tax obligations. Consequently, the couple decided to form a limited company through which Mr Jones would offer consulting services.

Acting on the advice of their accountants, Mr and Mrs Jones each acquired one of the two outstanding shares of an off-the-shelf company, Arctic Systems Limited (Arctic), from the original subscribers for a price of £1 per share. Mr Jones was appointed sole director. Mrs Jones agreed to handle the financial and administrative requirements of the company and to act as company secretary. At all relevant times the company's business consisted entirely in providing Mr Jones's services to outside users, through agencies, for fees. The record indicates that in a little more than a four-year period, Arctic provided his services to only three agencies and through them to only four clients. Given this level of activity and the nature of the services Mr Jones was providing, it is not surprising that Mrs Jones spent on average only four or five hours per week on company business. Having regard to all the circumstances, it is not unreasonable to describe Arctic as

basically a one-man operation,<sup>715</sup> but it can also reasonably be described as a joint (though unequal) effort of the two spouses along the lines discussed in Chapter 4 in the section on attributing income from joint activity.<sup>716</sup>

At the outset Mr and Mrs Jones decided that the company would pay them both salaries to meet their basic needs, with any profits distributed as dividends. Except for two years when Mr Jones drew a full salary and no dividends were paid to Mrs Jones because he mistakenly believed the IR 35 rules applied,<sup>717</sup> that plan was carried out. Although there is some confusion in the reported decisions as to the actual amounts involved, Park J proceeded on the basis that the company's turnover in the tax year at issue was approximately £91,000, from which Mr Jones was paid a salary of about £7,000 (far below the salary he could command in the market) and Mrs Jones about £4,000 (assumed throughout to be adequate compensation for her services). After other administrative expenses and corporation tax, the company earned a net profit of approximately £60,000 and paid dividends of about £30,000 to each of Mr and Mrs Jones. The dividend cheques were deposited into the couple's joint bank account. If the dividends had all been paid to him, the overall tax payable would have been higher, a fact Mr Jones admittedly understood.

HMRC reassessed Mr Jones under the settlements provisions for tax on the full amount of the dividends paid to his wife. Mr Jones appealed his assessment, and the

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<sup>715</sup> This view is shared by Martin Riley: see 'A Sympathetic Approach' (20 January 2005) 154 Taxation 361, 363.

<sup>716</sup> See text beginning at n 579.

<sup>717</sup> These personal services company rules are discussed in more detail in Chapter 6; see text at n 948.

appeal was heard by two Special Commissioners: Dr Brice, presiding, and Miss Powell.<sup>718</sup> Quite unusually, they were unable to reach an agreement on the outcome. Dr Brice accepted HMRC's position that the settlements provisions applied and the outright gift exception in ICTA 1988 section 660A(6) did not. Miss Powell disagreed on both issues and was in favour of allowing the taxpayer's appeal.<sup>719</sup> By regulation, in the event of such a deadlock, the Special Commissioner presiding at the hearing is entitled to exercise a second or casting vote.<sup>720</sup> Dr Brice exercised her casting vote in favour of HMRC, and the taxpayer's appeal was dismissed. The taxpayer was unsuccessful on appeal to the High Court, but this decision was reversed by a unanimous Court of Appeal. The Court of Appeal's decision (though not its reasoning) was eventually upheld unanimously on further appeal to the House of Lords.

The case received considerable media attention and Mr and Mrs Jones were even named 'Tax Personality of the Year' at the 2006 Lexis-Nexis Butterworths tax awards.<sup>721</sup> It has been estimated that there are thousands of couples in the UK in situations like Mr and Mrs Jones who were undoubtedly pleased by the taxpayer's victory in *Jones v Garnett*.<sup>722</sup> However, the day after the House of Lords gave its judgement, the Government announced its intention to introduce new legislation to 'clarify' the law as it

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<sup>718</sup> *Jones v Garnett* [2005] STC (SCD) 9 (*Jones* (SC)).

<sup>719</sup> For commentary on the Special Commissioners decision see Mark Robson, 'Jones v Garnett: Settlements and All That' [2005] BTR 15.

<sup>720</sup> Special Commissioners (Jurisdiction and Procedure) Regulations 1994 SI 1994/1811 Reg 18(2).

<sup>721</sup> Clay Harris, 'Fighters Rewarded' *Financial Times* (London 25 May 2006) 12.

<sup>722</sup> Harris (n 721).

applies to the taxation of family income-splitting arrangements. In a written statement to Parliament, the Exchequer Secretary to the Treasury, Angela Eagle, stated:<sup>723</sup>

‘The Government acknowledges the judgement given by the House of Lords in the Jones v Garnett (Arctic Systems) case. The Government is committed to maintaining fairness in the tax system. The case has brought to light the need for the Government to ensure that there is greater clarity in the law regarding its position on the tax treatment of ‘income splitting’.

Some individuals use non commercial arrangements (arrangements that they would not reasonably enter into with an arms-length third party) to divert income (which would, in the absence of those arrangements have flowed to them) to others. That minimises their tax liability, and results in an unfair outcome, increasing the tax burden on other tax payers and putting businesses that compete with these individuals at a competitive disadvantage.

It is the Government’s view that individuals involved in these arrangements should pay tax on what is, in substance, their own income and that the legislation should clearly provide for this. The Government will therefore bring forward proposals for changes to legislation to ensure this is the case. In the meantime, HMRC will apply the law as elucidated by the House of Lords and will be providing guidance in due course.

The Government would not want commercial arrangements to be caught by any change to legislation. Consultation should help to ensure this.’

Thus, it was quickly apparent that the Government was intent on further developing its policy towards family income-splitting arrangements. In the October 2007 Pre-Budget report, the Chancellor announced that the Government would be launching a consultation on draft rules aimed at preventing individuals from gaining a tax advantage by shifting

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<sup>723</sup> Hansard HC, col 89-90 (26 July 2007 WS)  
<<http://www.publications.parliament.uk/pa/cm200607/cmhansrd/cm070726/wmstext/70726m0001.htm>> accessed 22 August 2007.

dividends or partnership profits to lower-taxed persons.<sup>724</sup> Draft legislation was duly released in December 2007. Since the new rules were intended to take effect for 2008-09, the consultation period obviously was not intended to be protracted.

An accompanying press note elaborated on relevant factors to consider when establishing whether income shifting had taken place, including: ‘work done by the individuals in the business, the investments made and the risks to which they are subject through the business’.<sup>725</sup> This is consistent with the Revenue’s approach in the Settlements Guide. However, in the 2008 Budget the Government backtracked, deciding to delay implementation of the new income shifting legislation until Finance Act 2009 in order to allow for a further period of consultation to ‘ensure that the legislation in this area provides clarity and certainty for businesses and their advisers.’<sup>726</sup> As mentioned in the Introduction to this thesis, in the November 2008 Pre-Budget Report the UK Government reiterated its concerns that such income shifting was unfair, but backed away from its plans to introduce legislation in Finance Act 2009 addressing the issue, citing the poor economic climate.<sup>727</sup> The Government warned, however, that it is merely ‘deferring action’ and ‘will keep this issue under review’.<sup>728</sup> In the meantime, HMRC responded to its defeat in *Jones v Garnett* by announcing that it will seek to settle open

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<sup>724</sup> HM Treasury, ‘2007 Pre-Budget Report and Comprehensive Spending Review’ (Cm 7227, 2007) [5.99]-[5.100].

<sup>725</sup> HM Treasury, ‘2007 Pre-Budget Report and Comprehensive Spending Review’, Press Notice 02 (n 411) 1-2.

<sup>726</sup> HM Treasury, ‘Budget 2008’ (n 3) [4.69].

<sup>727</sup> HM Treasury, ‘Pre-Budget Report November 2008’ (n 5) [5.103].

<sup>728</sup> HM Treasury, ‘Pre-Budget Report November 2008’ (n 5) [5.103].

files with facts similar to *Jones v Garnett* in line with the House of Lords decision ‘unless there are any additional factors which might cause [HMRC] to take a different view’.<sup>729</sup>

The next section of this Chapter undertakes a doctrinal analysis of the settlements provisions, focusing on the key definitions in the legislation—namely ‘settlement’, ‘arrangement’, ‘settlor’, and ‘outright gift’, as well as the common law ‘bounty’ requirement—and considers their application in the context of family businesses. Chapter 6 of this thesis will evaluate the government’s initial legislative response<sup>730</sup> as well as several possible alternative approaches the Government could have taken to deal with this issue in the round.

#### (a) Arrangement

In attempting to ascertain the meaning of the word ‘arrangement’ in the settlements provisions the courts have begun by considering various dictionary definitions, including ‘a structure or combination of things for a purpose’ and ‘a number of objects arranged or combined in a particular way’.<sup>731</sup> Such broad definitions illustrate the potentially wide scope of the settlements provisions. The 1939 case *Copeman v Coleman*<sup>732</sup> provides the authority for two key preliminary points: first, that a settlement can exist without the creation of a trust; and second, that a corporate structure from which income arises in the

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<sup>729</sup> HM Revenue & Customs, ‘Guidance on Arctic Systems’ (July 2007) <<http://www.hmrc.gov.uk/practitioners/sba.htm>> accessed 22 August 2007.

<sup>730</sup> See text at n 890.

<sup>731</sup> *Jones (CA)* (n 713) [71]. Morritt C cites the Shorter Oxford English Dictionary and New Shorter Oxford English Dictionary definitions.

<sup>732</sup> (1939) 22 TC 594 (KB).

form of dividends is capable of being a settlement. In *Copeman v Coleman*, a company owned jointly by a husband and wife allotted preference shares of £200 to the couple's minor children in return for £10 from the children's own money. The company then declared a dividend of £40 on each preference share, and the father claimed repayment of tax on the dividend on behalf of his children. Lawrence J held that this was not a bona fide commercial transaction and constituted an 'arrangement'. The propositions established in *Copeman v Coleman* have been confirmed in two more recent cases,<sup>733</sup> and again in *Jones v Garnett*.<sup>734</sup> They are also consistent with the position taken by the Revenue in the Settlements Guide, since the guidance therein is focused primarily on non-trust situations, including corporate structures giving rise to dividend income.<sup>735</sup>

In the family business income-splitting context, the leading cases pre-*Jones v Garnett* in which an arrangement and thus a statutory settlement was found to exist are *Butler v Wildin*<sup>736</sup> and *Crossland v Hawkins*.<sup>737</sup> In *Butler v Wildin*, two brothers, Graham and Garry Wildin, entered into negotiations with British Rail in 1980 to acquire a long lease on a disused railway yard with a view to developing the land into an office and shopping block. The brothers purchased an off-the-shelf company, initially taking shares but soon after allocating all the share capital to their minor children. The children paid the par value of £1 for each share acquired with money from building society accounts in their names funded by gifts from their grandparents. The brothers then arranged for the

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<sup>733</sup> *Butler v Wildin* (1988) 61 TC 666 (Ch), and *Young v Pearce* (1996) 70 TC 331 (Ch).

<sup>734</sup> *Jones* (HC) (n 2) [21].

<sup>735</sup> Settlements Guide (n 2) [2.2].

<sup>736</sup> *Butler v Wildin* (n 733).

<sup>737</sup> (1961) 39 TC 493 (CA).

company to acquire the lease and undertake the development. The brothers remained as sole directors, and the company's principal source of funds was a bank loan guaranteed by them. In 1985, an interim dividend of £84 was declared, and the brothers submitted claims for repayment of the tax credit attributable to the dividends paid to their children (all of whom had no other significant income).

The Special Commissioner ruled in the brothers' favour, but the Revenue succeeded on appeal to the Chancery Division. Vinelott J held that the brothers were party to an 'arrangement' for purposes of the settlements provisions (as they then read<sup>738</sup>):<sup>739</sup>

'The brothers together arranged for shares in the company to be allotted to the...children; and they arranged for negotiations with British Rail to be opened, for the agreement with British Rail to be entered into and for the site to be developed by the company. The steps they took were throughout directed to achieving the end that was in fact achieved, namely of ensuring that the company and so indirectly the...children...took the benefit of the development of the site at no cost or risk to themselves.'

The *Crossland v Hawkins* case concerned a film actor, Jack Hawkins, who on the advice of accountants entered into an employment contract with a service company for a low salary. The shares in the service company were owned by trustees of a trust set up by Mr Hawkins' father-in-law for the benefit of Mr Hawkins' three minor children. The service company contracted with a film company to provide Mr Hawkins' services for a substantial fee. After paying a small salary to Mr Hawkins, the company was left with a

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<sup>738</sup> ICTA 1970 ss 437, 442 and 444.

<sup>739</sup> *Butler v Wildin* (n 733) 683-84. It should be noted that Vinelott J expressed serious reservations as to whether the minor children were genuinely shareholders and whether the dividend had properly been paid ('These facts seem to me artificial and unreal'), but he proceeded on the basis that the facts were as admitted or found by the Special Commissioner.

large after-tax profit which was paid as dividends to the trustees who then paid the dividends on as income to the children.

The Court of Appeal in *Crossland v Hawkins* held that the formation of the company, the services agreement and the deed of settlement together formed an arrangement that constituted a statutory settlement, and that Mr Hawkins provided funds and was therefore a settlor of that settlement. Donovan LJ stated:<sup>740</sup>

‘I do not think that the language of section 397 requires that the whole of the eventual arrangement must be in contemplation from the very outset....I think there is sufficient unity about the whole matter to justify it being called an arrangement for this purpose, because, as I have said, the ultimate object is to secure for somebody money free from what would otherwise be the burden or the full burden of surtax. Merely because the final step to secure this objective is left unresolved at the outset, and decided on later, does not seem to me to rob the scheme of the necessary unity to justify it being called an “arrangement”.’

Donovan LJ’s reasoning in *Crossland v Hawkins* was affirmed and applied by the House of Lords in *Mills v IRC*,<sup>741</sup> the facts of which are quite similar to those in *Crossland v Hawkins*. In *Mills v IRC*, the sizeable earnings of a successful actor (the child star Hayley Mills) were paid to an intermediary company that had contracted with the actor at a low fee to provide her services to others. The earnings were then distributed as dividends to a trust of which she was beneficiary. The House of Lords held that this constituted a statutory settlement.

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<sup>740</sup> *Crossland v Hawkins* (n 737) 549-50.

<sup>741</sup> [1975] AC 38 (HL).

The potentially quite broad scope of the definition of ‘settlement’, and in particular the word ‘arrangement’, was confirmed recently by the House of Lords in *Jones v Garnett*. Lord Hoffmann (with whom all the other judges said that they agreed)<sup>742</sup> and Lord Walker (in separate reasons)<sup>743</sup> specifically adopted the passage cited above from Donovan LJ’s judgment in *Crossland v Hawkins* where he refers to ‘sufficient unity.’<sup>744</sup> Lord Walker went on to add:<sup>745</sup>

‘The Court has been reluctant to try to lay down any precise test for identifying the components of an arrangement or for assessing the “sufficient unity” to which Donovan LJ referred....In my opinion the Court’s caution has been well-advised. “Arrangement” is a wide, imprecise word. It can (like “settlement” or “partnership” or indeed “marriage”) refer either to actions which establish some sort of legal structure (in this case, a corporate structure through which the taxpayer’s income could be channelled) or those actions together with the whole sequence of what occurs through, or under, that legal structure, in accordance with a plan which existed when the structure was established. The planned result may be far from certain of attainment. It may be subject to all sorts of commercial contingencies over which the taxpayer has little or no control. But if the plan is successful and income flows through the structure which he has set up, it is “income arising under the settlement.”’

As a result, post-*Jones v Garnett* it now appears clear that the courts are content to allow ‘arrangement’ to have a broad, imprecise meaning for the purposes of the settlements provisions. So long as there is sufficient unity to the taxpayer’s actions they will be capable of being an arrangement for this purpose, even where the planned result is not certain and/or subject to contingencies beyond the taxpayer’s control.

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<sup>742</sup> *Jones* (HL) (n 713) [13].

<sup>743</sup> *Jones* (HL) (n 713) [49].

<sup>744</sup> Text at n 740.

<sup>745</sup> *Jones* (HL) (n 713) [50].

### (i) The Common Law ‘Bounty’ Requirement

While the scope of the word ‘arrangement’ is quite broad, that is not the end of the matter because the cases also have established that before an arrangement can be within the definition of settlement an element of ‘bounty’ must be present.<sup>746</sup> The existence of bounty has been variously described as ‘a taxpayer giving away a portion of his income, or of his assets’, ‘a flavour of donation’ or ‘the recipient benefits without any assumption by him of any correlative obligation’.<sup>747</sup> In *Chinn v Collins*, Lord Roskill cautioned that the word ‘bounty’ appears nowhere in the statute, and described it as ‘a judicial gloss on the statute descriptive of those classes of cases which are caught by the section in contrast to those that are not.’<sup>748</sup> Similarly, in *IRC v Plummer*, Lord Wilberforce stated:<sup>749</sup>

‘[The settlements provisions], in other words, though drafted in wide, and increasingly wider language, are nevertheless dealing with a limited field – one far narrower than the field of the totality of dispositions, or arrangements, or agreements, which a man may make in the course of his life. Is there then any common description which can be applied to this?’

The courts which, inevitably, have had to face this problem, have selected the element of “bounty” as a necessary common characteristic of all the “settlements” which Parliament has in mind.’

Park J in *Jones v Garnett* described Lord Wilberforce’s speech in *IRC v Plummer* as settling the position that some element of bounty is required to come within the

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<sup>746</sup> Most notably *Bulmer v IRC* (1966) 44 TC 1 (Ch) and *IRC v Plummer* [1980] AC 896 (HL).

<sup>747</sup> *Jones (CA)* (n 2) [72], referring to *IRC v Plummer* (n 746) and *Chinn v Collins* [1981] AC 533 (HL) 555.

<sup>748</sup> *Chinn v Collins* (n 747) 555.

<sup>749</sup> *IRC v Plummer* (n 746) 912.

settlements provisions,<sup>750</sup> and *Morritt C* agreed.<sup>751</sup> The House of Lords took the same view, with Lord Hoffmann describing the ‘bounty’ requirement as follows:<sup>752</sup>

‘This old-fashioned phrase.... conjuring up the image of Lady Bountiful in *The Beaux’ Stratagem*, is perhaps not the happiest way of describing a provision for a spouse or minor children. A donation to a spouse or child is traditionally expressed in a deed to be “in consideration of natural love and affection” rather than the donor’s bounty. It is nevertheless exactly the kind of thing at which the anti-avoidance provisions are aimed.’

Lord Hoffmann concluded that the general effect of the cases is that the settlor must provide a benefit under the arrangement that would not have been provided in a transaction at arm’s length.<sup>753</sup> Baroness Hale, while agreeing with Lord Hoffmann, expressed even more displeasure with the ‘patronising and inaccurate term “bounteous”’ in her reasons, preferring instead to use the term ‘gratuitous’.<sup>754</sup>

Consequently, although the term ‘bounty’ appears nowhere in the settlements provision, it is now well established by the cases that an arrangement must be bounteous before the provisions will apply. This means that the potentially quite broad scope of the provisions is not quite as broad as might at first glance appear. Interestingly the Tax Law Rewrite Committee made no attempt to incorporate the bounty requirement into ITTOIA when the settlements provisions were rewritten, and the explanatory notes to the draft bill

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<sup>750</sup> *Jones* (HC) (n 2) [31]. Nourse J came to a similar conclusion in *IRC v Levy* (1982) 56 TC 68 (HC) 87.

<sup>751</sup> *Jones* (CA) (n 2) [14]–[17], [19].

<sup>752</sup> *Jones* (HL) (n 713) [70].

<sup>753</sup> *Jones* (HL) (n 713) [7].

<sup>754</sup> *Jones* (HL) (n 713) [22].

make no mention of it.<sup>755</sup> The Settlements Guide also has surprisingly little to say on the bounty requirement. The Revenue merely acknowledge that the courts have limited the scope of a statutory settlement in this way, and then defines bounty as broadly the provision of value without any corresponding quid pro quo, usually a gift or a transfer at less than full value.<sup>756</sup>

## (ii) Bounteous Arrangement in the Family Business Income-Splitting

### Context

Whilst the commissioners and judges hearing *Jones v Garnett* all agreed that an element of bounty was necessary in order to have a statutory settlement, there was considerable disagreement as to whether a bounteous arrangement existed in Mr and Mrs Jones's situation. By way of background, counsel for HMRC, relying on *Mills v IRC* and *Crossland v Hawkins*, argued that the corporate structure whereby (a) Mr Jones was responsible for earning all the income of Arctic, (b) he drew only very small remuneration, and (c) substantial dividends were expected to be paid of which half would go to Mrs Jones on her 50% interest in Arctic, was an 'arrangement' for the purposes of the settlements provisions, and Mr Jones was the 'settlor' of that settlement. Counsel's argument is consistent with the Revenue's position in the Settlements Guide, wherein the Revenue state that it is essential to look at the whole arrangement when considering

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<sup>755</sup> In contrast, the draft Income Tax (Trading and Other Income) Bill incorporated the rule in *Sharkey v Wernher* [1956] AC 58 (HL), though it was dropped from ITTOIA on the basis that some disputed its application: see Tax Law Rewrite Committee, 'Responses to the Draft Income Tax (Trading and Other Income) Bill' (23 September 2004) <[http://www.hmrc.gov.uk/rewrite/exposure/rd\\_tlr\\_resp.pdf](http://www.hmrc.gov.uk/rewrite/exposure/rd_tlr_resp.pdf)> accessed 16 April 2006.

<sup>756</sup> Settlements Guide (n 2) [3.6].

whether the settlements legislation applies. Such arrangement could be embodied in a formal document, but need not be (as was the case in the Jones's situation), and could involve one transaction or a series of transactions, including commercial transactions.<sup>757</sup>

Dr Brice agreed with counsel for HMRC. On the crucial question of bounty, she held that although Mr Jones was not bound to draw a market salary from the company, his decision not to do so and instead declare a dividend in some years was an act of bounty in those years.<sup>758</sup> Miss Powell disagreed, finding that there was no element of bounty in the arrangement because Mr Jones was no worse off at the crucial time – when Mrs Jones acquired her share – merely because he *intended* to provide bounty: ‘An intention to provide bounty is not the same as the provision of bounty.’<sup>759</sup>

In his case comment on the Special Commissioners' decision, Robson discussed in some detail the law on bounty in the settlements provisions context.<sup>760</sup> He concluded that the cases had established that the requisite element of bounty has to be established at the outset, ie when Mrs Jones acquired her Arctic share. Furthermore, in his view, the authorities did not provide any support for the view that working at an undervalue can of itself provide bounty, through generating retained profits. He was unclear if Dr Brice's conclusion was a misunderstanding or a significant extension of the concept of bounty as it has been applied by the courts to the settlements provisions.

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<sup>757</sup> Settlements Guide (n 2) [3.3]–[3.4].

<sup>758</sup> *Jones* (SC) (n 718) [61].

<sup>759</sup> *Jones* (SC) (n 718) [126].

<sup>760</sup> Robson (n 719) 18-20.

Notwithstanding Robson's views, Park J agreed with Dr Brice. He accepted Miss Powell's position that there was a difference between a present intention to provide bounty and the actual provision of it later, but concluded that this difference was of no significance, stating:<sup>761</sup>

'If a structure is being established in circumstances where one of the reasons for it is that it will or will be available to be used as a means through which bounty will or may be channelled to another person in future, that is in my view fully within what the cases contemplate as an arrangement covered by the statutory definition.'

In arriving at this conclusion, Park J acknowledged that there was no means of knowing whether Arctic would succeed in finding outside clients willing to pay for Mr Jones's services, nor was it certain what salary Mr Jones would draw and thus what profits would be available in the company for distribution as dividends. However, he concluded: 'In my view the point of having one share acquired by Mrs Jones (or at least one of the points) was that she should in future be in a position to receive dividends which, if and when she did receive them, would plainly come to her as bounty.'<sup>762</sup> He found that the situation in *Jones v Garnett* was effectively covered by the Court of Appeal's decision in *Crossland v Hawkins*. Although there were some factual differences between the structures in *Crossland v Hawkins* and *Mills v IRC*, on the one hand, and *Jones v Garnett* on the other (Jack Hawkins had signed a medium-term employment contract with the company at a modest salary, for example, while Mr Jones had no signed employment contract with Arctic), Park J concluded that those factual discrepancies made no difference.

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<sup>761</sup> *Jones* (HC) (n 713) [35].

<sup>762</sup> *Jones* (HC) (n 713) [35].

The Court of Appeal in *Jones v Garnett* disagreed with Park J. Morritt C accepted HMRC's contention that the arrangement in the case included the acquisition by Mrs Jones of her share in Arctic from the formation agents for £1, but found that that acquisition, viewed on its own, was for full value in the context of a joint business venture to which both parties made substantial and valuable commitments.<sup>763</sup> He further accepted that on a broader view of the arrangement it could include the corporate set-up whereby Mr Jones had the ability as sole director to confer benefit, but, crucially, he found that that set-up did not, of itself confer benefit.<sup>764</sup>

Having found that the corporate set-up was no more bounteous than Mrs Jones's acquisition of her Arctic share, the Chancellor turned to HMRC's argument that the requisite bounty was provided subsequently by the combination of the demand and charge-out rate for the services of Mr Jones, the salary in fact paid to Mr Jones, the other commitments of Arctic and the dividends subsequently declared by Mr Jones as sole director and paid by Arctic to Mrs Jones. The Chancellor rejected HMRC's theory. He found that all of these additional elements depended on the will of Mr Jones, since he did not commit himself to working for Arctic at any particular rate of salary or at all, or on wholly extraneous factors, such as the demand for Mr Jones's services and the going market rate.<sup>765</sup> The Chancellor concluded:<sup>766</sup>

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<sup>763</sup> *Jones* (CA) (n 713) [73].

<sup>764</sup> *Jones* (CA) (n 713) [74].

<sup>765</sup> *Jones* (CA) (n 713) [75].

<sup>766</sup> *Jones* (CA) (n 713) [75]–[76].

‘For my part, I do not think that these elements can be included in the “arrangement”. They did not form any part of a structure or things or combinations of objects; their uncertainty and fluidity is the converse of an arrangement. It is not that they were not legally enforceable, they were not settled at all. No doubt Mr and Mrs Jones hoped for the best but it cannot be said that they had arranged it. Without these elements there was no element of bounty and no settlement within the statutory definition.’

Keene LJ agreed with the Chancellor that no settlement existed in the Jones’s situation. He emphasised that those matters which constitute the arrangement and hence the settlement must be identifiable by a particular point in time, as opposed to there being something which may or may not turn out to be a settlement if certain future events happen.<sup>767</sup> While initially attracted to HMRC’s position that the expectation that Mr Jones would draw a below-market salary existed at the time of acquisition of the Arctic shares, Keene LJ ultimately found that HMRC were seeking to include within the scope of the arrangement matters which were, at the relevant date, ‘too speculative and too uncertain’, depending as they did upon how well the company performed and other factors, as well as subsequent decisions made by Mr Jones as sole director.<sup>768</sup> He could not regard ‘such a Protean state of affairs’ as capable of being part of an arrangement in the sense used in the legislation.<sup>769</sup>

Carnwath LJ also agreed with the Chancellor, adding (and Keene LJ agreeing) that HMRC’s position in the case represented a significant extension of the existing

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<sup>767</sup> *Jones* (CA) (n 713) [101].

<sup>768</sup> *Jones* (CA) (n 713) [102].

<sup>769</sup> *Jones* (CA) (n 713) [102].

jurisprudence in an area where the lack of a clearly ascertainable legislative purpose warranted caution.<sup>770</sup>

‘For the first time, [HMRC] seek to apply the concept [of settlement] to what has been found to be a normal commercial transaction between two adults, to which each is making a substantial commercial contribution, albeit not of the same economic value. Such a difference, by itself is not enough to my mind to take the arrangement into the realm of “bounty”, as it has been understood in the existing cases. If the legislature wishes such an arrangement to be brought within a special regime for tax purposes, clearer language is necessary to achieve it.’

In the House of Lords, all five of the Law Lords accepted that the Mr and Mrs Jones had entered into a bounteous arrangement. Lord Hoffmann (with whom all the other judges said that they agreed) rejected Carnwath LJ’s approach outright, stating:<sup>771</sup>

‘I cannot agree that this was a “normal commercial transaction between two adults.” It made sense only on the basis that the two adults were married to each other. If Mrs Jones had been a stranger offering her services as a book keeper, it would have been a most abnormal transaction. It would not have been an arrangement into which Mr Jones would ever have entered with someone with whom he was dealing at arms’ length. It was only “natural love and affection” which provided the consideration for the benefit he intended to confer upon his wife. That is sufficient to provide the necessary “element of bounty”.’

Lord Hoffmann also added that he would have found it difficult to say that in *Butler v Wildin* the subsequent agreement with British Rail and the development were part of the arrangement. He agreed with Morritt C that they depended upon extraneous events and decisions which had not been made.<sup>772</sup> As a result, Lord Hoffmann took a less expansive

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<sup>770</sup> *Jones* (CA) (n 713) [108].

<sup>771</sup> *Jones* (HL) (n 713) [24].

<sup>772</sup> *Jones* (HL) (n 713) [22].

view of what comprised the arrangement then the Revenue had argued and Park J had accepted, stating:<sup>773</sup>

‘It was the *expectation* of such events and the hope of profit which, together with the absence of any risk attached to the children’s ownership of the shares, gives the “element of bounty” to the arrangement constituted by the allotment. What subsequently actually happened was not part of the arrangement but the way in which (as foreseen) income arose under the arrangement. I think that this analysis (which Keene LJ said he had initially found persuasive) is correct.’ [emphasis in original]

Thus, it was the allotment of the Arctic share to Mrs Jones that was, in Lord Hoffmann’s words, the essence of the bounteous arrangement.<sup>774</sup> Lord Walker came to a similar conclusion, although he framed his description of the arrangement slightly differently, and more broadly, than Lord Hoffmann, stating:<sup>775</sup>

‘...the establishment of the corporate set-up, together with the common intention that Mr and Mrs Jones would use it to minimise tax in accordance with their accountants’ advice, was the essential arrangement. What happened afterwards was that the arrangement was put to its intended use.’

Lord Neuberger (with whom all the other Lords except Lord Hoffmann also said that they agreed) agreed with the reasons of Lords Hoffmann and Walker. With language reminiscent of Park J<sup>776</sup>, Lord Neuberger expanded on the relevance of the future events

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<sup>773</sup> *Jones* (HL) (n 713) [22].

<sup>774</sup> *Jones* (HL) (n 713) [29].

<sup>775</sup> *Jones* (HL) (n 713) [54].

<sup>776</sup> Text at n 761.

(eg the low salary drawn by Mr Jones, the dividend payments) to the determination of whether the arrangement contained the necessary element of bounty:<sup>777</sup>

‘It seems clear that, when considering whether there was an ‘arrangement’ within the meaning of the sections, i.e. an arrangement which involved an element of bounty, one should assess the position at the time that the alleged arrangement was made, but, in carrying out that exercise, one should not disregard what happened thereafter. In particular, if the parties intended an element of bounty to accrue, and that element of bounty does indeed eventuate, then, absent any other good reason to the contrary, there is indeed an ‘arrangement’ within the meaning of subsection 660(G)(1).’

As a result, in *Jones v Garnett* the arrangement was made at the time the ordinary share in Arctic was transferred to Mrs Jones. Although later events could constitute part of the arrangement in other fact patterns, as Lord Hoffmann thought appeared to be the case in *Crossland v Hawkins*,<sup>778</sup> in situations such as in *Butler v Wildin* and *Jones v Garnett* they may be only factors to consider in determining whether the arrangement has the necessary element of bounty to constitute a statutory settlement. Thus, in *Jones v Garnett*, the events occurring after the allotment, namely the revenue Mr Jones was able to secure for Arctic from providing his services as an IT consultant for an artificially-low salary, and the payment of dividends to Mr and Mrs Jones, were not part of the arrangement. However, that did not mean that these future events were to be disregarded entirely; they were relevant to the issue of whether the arrangement contained the necessary element of bounty. This is most clearly evident in Lord Neuberger’s reasons when he stated:<sup>779</sup>

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<sup>777</sup> *Jones* (HL) (n 713) [79].

<sup>778</sup> *Jones* (HL) (n 713) [22].

<sup>779</sup> *Jones* (HL) (n 713) [88].

‘The essential point here is that, in the light of reasonable expectations as to what Mr Jones would achieve in terms of winning contracts for the company and would be prepared to accept by way of remuneration (*which expectations were in due course fully realised*), the value in 1992 to Mrs Jones of her share was considerably greater than the £1 which she paid. In those circumstances, there was indeed an element of bounty involved in her acquisition of the share, and that bounty was provided through the expectation of what Mr Jones would do.’ [emphasis added]

Thus, in Lord Neuberger’s opinion, the bounty arose because the share allotted to Mrs Jones was worth substantially more than the £1 she paid for it given the expectations associated with the arrangement. Lord Hoffmann also observed that the value of a share depends upon expectations of future yield,<sup>780</sup> and that it was Mr Jones’s consent to the transfer of a share with expectations of dividend to Mrs Jones for £1 which provided the element of bounty.<sup>781</sup>

Finally, although Baroness Hale ultimately agreed with the other Lords, it is worth noting that she expressed some serious reservations as to whether an arrangement existed in *Jones v Garnett* at all, for reasons similar to those of Morritt C:<sup>782</sup>

‘Thus my reservations about the Revenue’s case that this is a settlement at all are very similar to those of the Chancellor: it only becomes a “settlement” within the meaning of section 660A(1) because of expectations about later events which are too uncertain and fluid to be included as part of the initial arrangement. However, in view of our unanimous conclusion that this appeal should be dismissed, it would be presumptuous of me to reach a different conclusion on the settlement point.’

### (iii) Conclusion on Bounteous Arrangement in the Family Business Context

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<sup>780</sup> *Jones* (HL) (n 713) [20].

<sup>781</sup> *Jones* (HL) (n 713) [28].

<sup>782</sup> *Jones* (HL) (n 713) [71].

The ease with which the Court of Appeal distinguished the situation in *Jones v Garnett* from the settlements found to exist in *Crossland v Hawkins* and *Mills v IRC* was troubling, and it is fortunate that the House of Lords did not follow their reasons. Whilst it is undoubtedly true that the actors Jack Hawkins and Hayley Mills had a better chance of generating profits for their employing companies than Mr Jones did for Arctic (though actors have been known to fall out of favour), exactly how much profit they would generate, what other commitments the companies would have and when and how much in the way of dividends would be declared appear to be questions no more certain at the outset of those arrangements than in the Jones's situation. Yet, in both *Crossland v Hawkins* and *Mills v IRC* the arrangement at issue was held to be a statutory settlement. It is also difficult to understand why the Court of Appeal determined that the absence of a service agreement should make such a difference to the outcome in *Jones v Garnett* given these precedents. Mr and Mrs Jones intended at the outset that Mr Jones would work for a small salary for Arctic and the company was to be the vehicle for delivering his consulting services. The fact that this intention was not formalised in a services agreement should not be enough to tip the balance on the existence of a statutory settlement one way or the other. Lord Hoffmann came to the same conclusion on this point, noting that the Wildin brothers were not obliged to fund the development of the company, and could have stopped at any time, but that fact did not stop the court from concluding in *Butler v Wildin* that a settlement existed.<sup>783</sup>

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<sup>783</sup> *Jones* (HL) (n 713) [20].

Furthermore, in several places the members of the Court of Appeal highlighted the fact that Mrs Jones made important and valuable contributions to the business. The Chancellor began his conclusion on the settlement issue by taking judicial notice of the increasing tendency for married couples to be involved in the business of each other on a commercial non-bounteous basis,<sup>784</sup> and a similar theme is found in Carnwath LJ's comments reproduced above.<sup>785</sup> The Chancellor also stated in the course of distinguishing *Crossland v Hawkins* and *Mills v IRC* that the beneficiaries under the settlements in those cases contributed nothing (a curious statement, as the Chancellor had correctly noted a few paragraphs earlier that Hayley Mills herself was the beneficiary of the settlement in that case).<sup>786</sup>

On the one hand, the extent of Mrs Jones's contribution to the business does not seem critical to the Court of Appeal's finding that the arrangement was too uncertain and too speculative at the outset to constitute an arrangement for the purposes of the settlements provisions. If Mrs Jones had made no contribution at all to Arctic's business, the uncertainty surrounding Mr Jones's ability to generate income for the company, the amount of salary he would draw, whether dividends would be declared and how much, would still be present on day one. On the other hand, the Chancellor found that Mrs Jones's acquisition of her share in Arctic from the formation agents for £1 was for full value in the context of a joint business venture to which both parties made substantial and valuable contributions. If she made no contributions to the business, would the

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<sup>784</sup> *Jones* (CA) (n 713) [70].

<sup>785</sup> *Jones* (CA) (n 713) [108].

<sup>786</sup> *Jones* (CA) (n 713) [77].

acquisition of her share in those circumstances have been enough to provide the requisite bounty? What if she contributed to the business, but just a few hours a month? If the Court of Appeal's reasoning had stood, the conclusion is far from certain. As it happened, none of the Law Lords focused on the extent of the Mrs Jones's contribution to the business, coming instead to the conclusion that bounty was involved.

Tiley has argued that whether the facts in *Jones v Garnett* amount to the 'arrangement' found narrowly, as the taxpayer wished, or widely, as HMRC contended, is largely a matter of interpretation and application of existing authorities.<sup>787</sup> He concluded that matters are 'finely balanced', stating:<sup>788</sup>

'One can reasonably believe that the matter is not quite as straightforward as Park J. would have us believe and still regard the Revenue case as a strong one. Others will find comfort in the approach of Carnwath L.J. that the Revenue's position in this case seemed to him to be a significant extension....'

It also should be noted that the income tax is an annual tax. In the Settlements Guide, the Revenue recognise that circumstances may change from year-to-year. For example, the salary paid to the fee-earner may be uncommercial for several years, which could mean any dividends paid to a non-fee earning spouse would be at risk of reassessment under the settlements provisions in those years, but then become commercial, in which case the settlements legislation may no longer apply to any dividends paid.<sup>789</sup> Unfortunately, this point was not advanced by either side in the *Jones v Garnett* litigation. Nevertheless,

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<sup>787</sup> Tiley (n 162) 298.

<sup>788</sup> Tiley (n 162) 298.

<sup>789</sup> Settlements Guide (n 2) [3.8.3].

Baroness Hale stated that she would have found it easier to understand the Revenue's case if it had adopted a year-by-year approach (along the lines suggested in the Settlements Guide):<sup>790</sup>

‘...looking at each tax year, has one of the spouses worked for a salary which is seriously less than his services are worth to the company in order to boost the company's profits which can then be distributed equally between the spouses as dividend? In other words, has there been a gratuitous transfer of income between husband and wife?’

In Baroness Hale's view, this would be ‘a practical way of catering for the uncertainties and vicissitudes of family life and family business’, while meeting the policy objectives underlying the settlements provisions.<sup>791</sup> Lord Neuberger (with whom the other Lords said they agreed) expressed the view that a year-by-year approach to whether an arrangement existed was ‘logically attractive’, but concluded that ‘it would be inconvenient in practice, in that it would be difficult to administer, and it might well produce unfair, even arbitrary, results.’<sup>792</sup>

As a result, the question of whether a family business enterprise that, for example, begins on commercial terms but in some later tax year becomes uncommercial is caught by the settlements provisions at that later stage was left unanswered by *Jones v Garnett*. On the facts in that case the essence of the arrangement was Mrs Jones's acquisition of her Arctic share. Notwithstanding Lord Neuberger's administrative concerns, a year-by-year approach to identifying statutory settlements, relying on hindsight if necessary, is, as

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<sup>790</sup> *Jones* (HL) (n 713) [68].

<sup>791</sup> *Jones* (HL) (n 713) [68].

<sup>792</sup> *Jones* (HL) (n 713) [89].

Baroness Hale argued, consistent with a purposive view of the settlements provisions as anti-avoidance legislation.

A recent Special Commissioner decision in favour of HMRC post-*Jones v Garnett* appears in effect to permit a flexible approach to the timing question where the nature of the ‘arrangement’ at issue warrants it. In *Buck v Revenue and Customs Commissioners*<sup>793</sup> the taxpayer owned 9,999 shares in a company and his wife owned the other one share outstanding. He waived his entitlement to dividends in 1999 and 2000 and substantial dividends were paid by the company to his wife. Sir Stephen Oliver concluded that the ‘irresistible inference’ from the facts was that the taxpayer waived his entitlements to the dividends as the first step in his plan that the dividend income should become payable to his wife.<sup>794</sup> Most importantly, the Special Commissioner concluded that even a simple plan like this to divert income to the taxpayer’s wife by waiving his dividend in the two years fell within the meaning of ‘arrangement’, and was bounteous because the waivers would not have happened had the taxpayer and his wife been operating at arm’s length; as a result, the settlements provisions applied.<sup>795</sup> It should be noted that whether or not the taxpayer had an income-shifting plan in mind when the company was formed is not discussed and is not relevant to the decision. Although this is only a special commissioner decision, Sir Stephen Oliver’s finding that the simple act of waiving a dividend can be considered a bounteous arrangement provides further evidence that the meaning of arrangement, and consequently the potential scope of the settlements

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<sup>793</sup> [2009] STC (SCD) 6.

<sup>794</sup> *Buck v Revenue and Customs Commissioners* (n 793) 9.

<sup>795</sup> *Buck v Revenue and Customs Commissioners* (n 793) 9.

provisions, is very broad indeed. Moreover, the provisions can be flexible enough to (in Baroness's Hale words) cater for the uncertainties and vicissitudes of family life and family business.

In summary, the House of Lords in *Jones v Garnett*, in reversing the Court of Appeal on the bounteous arrangement issue, gave effect to the intention of the settlements provisions. The word 'arrangement' is capable of having a wide-meaning, but that is precisely the point. As Lord Roskill put it in *Chinn v Collins*: 'My Lords, I would venture to point out that the word 'bounty' appears nowhere in the statute.... The courts must, I think, be extremely careful not to interpret this descriptive word too rigidly.'<sup>796</sup> Tiley speculated that when the House of Lords came to hear *Jones v Garnett* they may do as they did in the divorce case *White v White*.<sup>797</sup> In *White v White*, the HL examined the 'reasonable requirements' common law gloss on the financial relief provisions in the Matrimonial Causes Act 1973 section 25 stemming from *O'Donnell v O'Donnell*<sup>798</sup> and insisted upon a return to the words of the statute. As it turned out, the Law Lords were not willing to restrict the established role of 'bounty'; they were content to approach the issue with caution<sup>799</sup> and, in Lord Hoffmann's words, take 'a broad and realistic view of the matter'.<sup>800</sup> As a result, the bounty requirement will not be difficult for HMRC to establish in future cases—so long as the arrangement at issue would have been entered into only by parties dealing otherwise than at arm's length. Moreover, the special

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<sup>796</sup> *Chinn v Collins* (n 747) 555.

<sup>797</sup> Tiley (n 162) 297 discussing *White v White* [2001] 1 AC 596 (HL) 606-7 (Lord Nicholls).

<sup>798</sup> [1975] 2 All ER 993 (CA).

<sup>799</sup> *Jones* (HL) (n 713) [50] (Lord Walker).

<sup>800</sup> *Jones* (HL) (n 713) [11].

commissioner decision in *Buck* that a dividend waiver can constitute an arrangement suggests the settlements provisions can be broad enough to apply on a year-by-year basis where appropriate. This is a satisfactory result. The courts should continue to maintain a broad, pragmatic view of bounty in situations involving income-splitting arrangements carried out through the family business, not only because the statutory language does not suggest any such requirement in the first place, but also because a finding of statutory settlement is not the end of the matter when spouses are involved—the outright gift exception will exclude arrangements that satisfy its tests.

#### (iv) Quantum of Bounty

Once an element of bounty has been established, the next question is what amount of dividends should properly be treated as income of the fee-earner instead of the actual recipient? Is it necessarily the entire amount? Although the House of Lords concluded that the arrangement in *Jones v Garnett* was bounteous, it could be argued that Mrs Jones is entitled to some level of return on her (small) capital investment in Arctic and to participate at least to some extent in the company's profitability (made possible partly through her efforts); should she not be taxable in her own right to some degree? The members of the Court of Appeal believed she should. Treating all her dividends as income of Mr Jones could indeed over-shoot the mark.

During the High Court hearing in *Jones v Garnett*, in response to a question from Park J, counsel for HMRC conceded that the quantum of dividends to which the settlements provisions would apply in the Jones's situation is the amount representing Mr

Jones's salary undervalue. If this is the case, it may be that something less than the full amount of dividends paid to Mrs Jones would be treated as Mr Jones's income. To take a simple example, assume the going market value salary for someone with Mr Jones's skills and experience is £50,000. This would mean his salary undervalue in the year in question would be £43,000 (£50,000 less the £7,000 salary he actually took). Since Arctic's profit after all expenses and taxes was £60,000, once the £43,000 salary undervalue is taken into account this still would leave profits of £17,000. Presumably, under this approach, dividends totalling £17,000 could be paid to Mr and Mrs Jones without risk of reassessment under the settlements provisions. As Mrs Jones owned 50% of the Arctic shares, HMRC's counsel's concession seems to suggest only £21,500 of the £30,000 dividend paid to Mrs Jones should be treated as her husband's income; she would be taxable on the remaining £8,500 (at the lower rate).

It should be noted that this concession is not consistent with HMRC's published guidance on the application of the settlements provisions to small businesses. As discussed above, the Settlements Guide states that if the fee-earner is working for an uncommercial rate of remuneration that will be one factor in determining whether the settlements provisions could be applied.<sup>801</sup> Whether the dividends paid represent a disproportionate return on capital investment is also cited as a factor to be taken into account.<sup>802</sup> At one point in the Settlements Guide, when discussing what the Revenue view as constituting an uncommercial salary, the Revenue cite the example of an IT

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<sup>801</sup> Text at n 705.

<sup>802</sup> Settlements Guide (n 2) [4.8]–[4.9].

employee earning £80,000 per annum who sets up her own IT consulting company.<sup>803</sup> If the company earns fees of £120,000, with expense of £20,000, HMRC would expect to see her drawing a salary of around £80,000; if instead she drew £40,000 with £40,000 going to a non-working spouse, the Revenue assert that this is likely to be an uncommercial arrangement. Interestingly, this example seems to suggest that so long as she drew £80,000, the remaining £20,000 could be paid to her non-working spouse. However, in example 11 in Annex A to the Settlements Guide, which is basically a situation identical to that of the Jones's, the Revenue make it clear that this is not the case. Rather, its position is that the full amount of the dividends paid to the fee-earner's wife should be treated as her husband's income, on the basis that he was paid an uncommercial salary and also because there is nothing to suggest that the dividend paid to her is a commercial return.<sup>804</sup> The Revenue make no attempt in example 11 to discern a market-value salary for the fee-earning husband or to limit the amount of his wife's dividends taxed in his hands to the amount of his salary undervalue.

Even assuming it is just the amount of salary undervalue that determines the quantum of dividends to which the settlements provisions apply in the Jones's circumstances, this could nevertheless result in Mr Jones being taxed on the full amount of the dividends paid to Mrs Jones. To the extent that there is any profit left over in Arctic after expenses have been paid (including Mr Jones's small salary and a reasonable salary for Mrs Jones), arguably this excess could be characterised as additional compensation derived from Mr Jones's services and/or his personal goodwill. It also can

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<sup>803</sup> Settlements Guide (n 2) [4.9.1].

<sup>804</sup> Settlements Guide (n 2) Annex A, example 11.

be argued that since he has chosen to accept this amount (plus a small salary) as an adequate return for providing his services through his one-man company (albeit permitting this return to be paid partly to his wife), rather than working for a salary in another company instead, it is more appropriate to determine the amount of the salary undervalue by reference to this additional profit amount rather than looking to his previous employment earnings or attempting to find a comparable market value salary figure. In the Settlements Guide, the Revenue do not make this point directly, but note that in the typical services company situation at risk of reassessment under the settlements provisions, goodwill is personal to the individual fee-earner and does not attach to the company.<sup>805</sup> Mr Jones's salary undervalue determined under this approach would vary from year to year depending on his level of activity and the rates he could charge, but these kind of fluctuations are not uncommon for many unincorporated traders and professionals as well as some employees when commissions and bonuses are taken into account.

In situations farther along the business activity spectrum, where the company has other employees, a large capital base, and/or the non-fee-earning spouse is making substantial (but less than equal) contributions to the profitability of the business, a market salary comparison (as HMRC advocate)<sup>806</sup> might be an acceptable method of arriving at the salary undervalue. Determining this market salary figure may not always be a particularly easy and certain exercise, but questions about reasonable, market-level salaries are not entirely unfamiliar in the small business context. For example, as

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<sup>805</sup> Settlements Guide (n 2) [4.7].

<sup>806</sup> Settlements Guide (n 2) [4.9].

discussed earlier in this Chapter, if family members are paid salary and wages in excess of a reasonable, commercial rate for the actual work they do for the family trading business, the expense, or some part of it at least, may not be deductible on the basis that the salary is not incurred ‘wholly and exclusively’ for the purposes of the trade.<sup>807</sup> It seems a reasonable extension of these principles to say that if the salary paid is instead below market value, there is a risk that the settlements provisions could apply with respect to the amount of the salary undervalue.

A more preferable solution, however, is to expressly provide a mechanism in the settlements provisions to allow the application of the arm’s length principle or a reasonableness test (as advocated in Chapter 4<sup>808</sup>) taking into account the *relative* contributions of the spouses in order to arrive at the appropriate quantum of bounty having regard to all the circumstances. This approach allows a spouse like Mrs Jones an adequate return on her capital invested (which may be minimal) but more importantly also allows her to share in the profits of the joint business activity to an extent commensurate with her contribution to the business (likely less than a 50-50 split in the Jones’s situation). This reform option is considered in Chapter 6.

#### (v) Settlor

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<sup>807</sup> See text at n 624.

<sup>808</sup> See text beginning at n 579.

As set out above, a ‘settlor’ is defined in ITTOIA as any person by whom the settlement is made.<sup>809</sup> Further, a person is treated as having made a settlement if the person has made or entered into the settlement ‘directly or indirectly’, which would include providing or undertaking to provide funds directly or indirectly for the purpose of the settlement.<sup>810</sup>

The interpretation of ‘settlor’ is less controversial than that of ‘settlement’. In *Mills v IRC*<sup>811</sup> the courts considered the meaning of the word ‘purpose’ in the definition of ‘settlor’. In the Court of Appeal decision in favour of the taxpayer, Lord Denning MR had concluded that the word ‘purpose’ connoted a mental element and for the taxpayer to have provided funds for the purpose of the settlement, she must have had the object – the end in view – of promoting the purposes of the settlement, and she was too young to have done so.<sup>812</sup> Buckley LJ held that the taxpayer did not have the necessary ‘motivating intention’ by the provision of funds to benefit those interested under the trusts.<sup>813</sup> The House of Lords, however, unanimously allowed the Revenue’s appeal. Viscount Dilhorne (the other Lords concurring) disagreed with Lord Denning MR that the word ‘purpose’ connotes a mental element, and with Buckley LJ that there must be a motivating intention.<sup>814</sup> Viscount Dilhorne did not consider it was incumbent, in order to establish that a person is a settlor as having provided for the purpose of a settlement, to show that

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<sup>809</sup> ITTOIA s 620(1).

<sup>810</sup> ITTOIA s 620(2).

<sup>811</sup> *Mills v IRC* (n 741).

<sup>812</sup> *Mills v IRC* [1972] 3 All ER 977 (CA) 988.

<sup>813</sup> *Mills v IRC* (CA) (n 812) 992.

<sup>814</sup> *Mills v IRC* (n 741) 52.

there was any element of *mens rea*. Instead, Viscount Dilhorne concluded that where it is shown that funds have been provided for a settlement, a very strong inference is drawn that they were provided for that purpose, an inference which will be rebutted if it is established that they were provided for another purpose.<sup>815</sup> On the facts in *Mills v IRC*, the House of Lords determined that there was no evidence that the funds were provided for any other purpose, and thus held that the taxpayer was a settlor of the settlement.

In *Jones v Garnett*, Dr Brice was of the view that Mr Jones was the settlor of the arrangement she identified because he directly entered into the arrangement and directly provided funds for the arrangement from his work as a computer consultant.<sup>816</sup> Park J similarly concluded that since Arctic's profits were attributable to Mr Jones's activities and the modest salaries he drew, there was little doubt that Mr Jones was the settlor of this arrangement. The taxpayer's counsel had also conceded that if Park J found there to be a settlement, Mr Jones would have been the settlor, and this point was not disputed in the Court of Appeal or in the House of Lords. In any event, Park J's conclusion is entirely consistent with Viscount Dilhorne's approach in *Mills v IRC*. As a result, it appears from *Mills v IRC* and *Jones v Garnett* that once an arrangement constituting a statutory settlement has been found to exist in a family dividend-sprinkling situations like that of the Jones's, it will follow almost automatically that the fee-earner spouse will be found to be a settlor.

## (b) Outright Gift Exclusion

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<sup>815</sup> *Mills v IRC* (n 741) 52.

<sup>816</sup> *Jones* (SC) (n 718) [66].

ITTOIA section 626 (formerly ICTA 1988 section 660A(6)) provides that income arising from settlement property is not treated as the income of the settlor in the case of an ‘outright gift’ by one spouse to the other of property from which the income arises so long as (A) the gift carries a right to the whole of the income and (B) the property is not wholly or substantially a right to income. Further, a gift is not an outright gift for the purposes of this exclusion if it is subject to conditions, or if there are any circumstances in which the property, or any related property, is or will be payable to or applicable for the benefit of the giver. Determining whether a gift is subject to conditions or whether the property will become applicable to the benefit of the giver are primarily questions of fact.

The outright gift exclusion from the settlements legislation ensures that genuine gifts between spouses are not caught by these rules. The policy arguments in support of allowing transfer of assets between spouses to be effective for capital income attribution purposes (including marriage neutrality and privacy/autonomy but also because it can lead to a fairer distribution of assets between spouses) are strong and were discussed at length in Chapter 4.<sup>817</sup> The meaning to be given to the expression ‘wholly or substantially a right to income’ as well as the more general question of what constitutes an ‘outright gift’ are discussed next.

### (i) Wholly or Substantially a Right to Income

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<sup>817</sup> See text at n 530.

Prior to *Jones v Garnett*, the leading case on whether shares in a family business were ‘wholly or substantially a right to income’ was *Young v Pearce*.<sup>818</sup> In that case, preference shares were issued to the wives of the two ordinary shareholders and directors of a small company. The preference shares carried the right to a dividend equal to 30% of the company’s net profits for a year provided the company resolved to distribute any part of its profits for that year; the ordinary shares carried a right to a dividend in respect of any balance of the profits resolved to be distributed. Preference shareholders were entitled to attend and to speak, but not to vote, at the company’s general meetings, and on liquidation the preference shareholders were entitled only to repayment of the nominal sums paid on the allotment of the shares. Dividends of £60,000, £40,000 and £36,000 were paid in the 1990, 1991 and 1992 tax years, respectively. The husbands were reassessed under the settlements provisions for tax on the dividends paid to their wives.

In the High Court, Sir John Vinelott found for the Revenue, holding that the creation of, application by each wife for, and allotment of the preference shares together constituted an arrangement or disposition and thus a statutory settlement.<sup>819</sup> Further, he held that the spousal outright gift exception did not apply because the property given (the preference shares) was wholly or substantially a right to income. Apart from the right to receive the preferential dividend if the taxpayers (the only directors) decided to distribute profits, the shares had only the limited rights described above. While as a matter of strict

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<sup>818</sup> *Young v Pearce* (n 733).

<sup>819</sup> *Young v Pearce* (n 733) 345.

legal principle the preference shares were assets distinct from the income derived from them, Sir John Vinelott concluded that in reality they could never have been realised.<sup>820</sup>

In the Settlements Guide, the Revenue state that a gift from one spouse to another of ordinary shares in a FTSE100 company would not be considered to be a gift of property that is wholly or substantially a right to income because the shares have a ‘capital value’ and can be traded.<sup>821</sup> A spousal gift of ordinary shares in a small private manufacturing company that owns factory and equipment and employs 10 people would also not be considered a gift of property that is wholly or substantially a right to income because the shares have ‘capital rights’ and the company has substantial assets so on the winding up or sale of the business the shares would have more than an insubstantial value.<sup>822</sup> On the other hand, the Revenue take the view that where ordinary shares in a consulting company with no substantial capital assets are gifted or subscribed for a nominal amount and the recipient/subscriber is not responsible for generating the consulting income of the company, the shares would be considered to be property that is wholly or substantially a right to income because the capital value of the shares is insignificant.<sup>823</sup> This conclusion appears to extend well beyond the *Young v Pearce*-type situation, and was tested in *Jones v Garnett*.

In *Jones v Garnett*, both of the Special Commissioners accepted that the arrangement could constitute an outright gift, but they disagreed over whether Mrs

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<sup>820</sup> *Young v Pearce* (n 733) 345-46.

<sup>821</sup> Settlements Guide (n 2) Annex A, example 23.

<sup>822</sup> Settlements Guide (n 2) Annex A, example 24.

<sup>823</sup> Settlements Guide (n 2) Annex A, examples 11 and 12.

Jones's share in Arctic was wholly or substantially a right to income. Proceeding on the assumption that she was wrong and there was a settlement, Miss Powell concluded that the exclusion in section 660A(6) would apply.<sup>824</sup> She considered that if Mrs Jones's share was part of a statutory settlement it was because the share was invested with value as a result of the bounty provided by Mr Jones, and therefore she believed it was not straining the language of the section to say that this was a gift by Mr Jones. Further, since Mrs Jones's share was an ordinary share, carrying with it the usual rights of such a share, including the rights to full participation in any proceeds of sale or liquidation and to attend and vote at meetings, her share could not properly be described as merely a right to income.<sup>825</sup>

Dr Brice, on the other hand, thought that section 660A(6) did not apply.<sup>826</sup> Bearing in mind the whole of the circumstances and the intentions of the parties, she concluded that Mrs Jones's share was, if not wholly, then substantially, a right to income.<sup>827</sup> She was unable to distinguish the ordinary shares from the preference shares in *Young v Pearce*,<sup>828</sup> which were non-voting and had no right to participate on a winding-up of the company. Surprisingly, Park J agreed with Dr Brice on this point, though 'with some hesitation.'<sup>829</sup> The hesitation is justified; it is difficult to see, even taking a broad view of the situation, how the ordinary shares in *Jones v Garnett* could be

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<sup>824</sup> *Jones* (SC) (n 718) [134].

<sup>825</sup> *Jones* (SC) (n 718) [135]–[136].

<sup>826</sup> *Jones* (SC) (n 718) [81].

<sup>827</sup> *Jones* (SC) (n 718) [81].

<sup>828</sup> *Young v Pearce* (n 733).

<sup>829</sup> *Jones* (HC) (n 713) [44].

considered to be indistinguishable from the non-voting preference shares in *Young v Pearce*. Morritt C helpfully addressed this point, stating that if he was wrong and a settlement did exist and it was an outright gift, then he would have concluded that Mrs Jones's ordinary share of Arctic was not substantially a right to income. Her share had exactly the same rights as Mr Jones's share and those rights, for example the right to share in a distribution of assets in the event of a wind-up and the right to vote at general meetings, constituted more than a mere right to income and were unaffected by the alleged arrangement.<sup>830</sup>

The Lords were unanimous that the 'outright gift' exception applied. Lord Hoffmann distinguished Mrs Jones's ordinary share from the shares held by the taxpayers' wives in *Young v Pearce* as follows:<sup>831</sup>

'The share [owned by Mrs Jones] was not wholly or even substantially a right to income. It was an ordinary share conferring a right to vote, to participate in the distribution of assets on a winding up, to block a special resolution, to complain under section 459 of the Companies Act 1985. These are all rights over and above the right to income. The ordinary share is different from the preference shares in *Young v Pearce*...which conferred nothing except the right to 30% of the net profits before distribution of any other dividend and repayment on winding up of the nominal amount subscribed for their shares. Those shares were substantially a right to share in the income of the company.'

Lord Hope agreed, going so far as to conclude that ordinary shares could never fall within the carve-out for outright gifts that are wholly or substantially a right to income:<sup>832</sup>

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<sup>830</sup> *Jones* (CA) (n 713) [97].

<sup>831</sup> *Jones* (HL) (n 713) [30].

<sup>832</sup> *Jones* (HL) (n 713) [38].

‘The rights which an ordinary shareholder enjoys are not confined wholly, or even substantially, to a right to income. The residue of the assets of the company belongs to the ordinary shareholders, after the rights of creditors and any preference shareholders have been satisfied. So property given which consists of ordinary shares in a company will always attract the exception in section 660A(6).’

The views of the Lords, Morritt C and Special Commissioner Powell on this point are preferable to that of Park J and the position adopted by the Revenue in the Settlements Guide. As Vaines argues, even though Mrs Jones was not a director, by virtue of owning 50% of the ordinary shares and 50% of the votes, Mrs Jones had the potential to exert considerable influence over the company’s affairs.<sup>833</sup> In addition, unless the Table A articles had been modified, Mr Jones would need to be re-elected as director each year, and he would have needed Mrs Jones to vote for him since the appointment of a director must be authorised by an ordinary resolution requiring more than 50% of the votes.<sup>834</sup> Furthermore, although directors recommend the payment of a final dividend, this payment must be approved by the members in general meeting. Therefore, Mrs Jones had full power on each occasion a final dividend payment was proposed to accept or reject the payment.<sup>835</sup> Finally, the Arctic shares had capital value. If at the outset of their arrangement Mr and Mrs Jones were asked if there was a possibility they might at some point decide to sell their shares, or liquidate their holdings, the answer undoubtedly would be ‘yes’. Admittedly her share need only be ‘substantially’ a right to income, but in these the circumstances Mrs Jones’s share was much more than that. Vaines comes to the same conclusion: ‘This is not wholly or substantially a right to income; this is wholly

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<sup>833</sup> Peter Vaines, ‘Arctic Systems: Director or Dictator?’ (28 October 2004) 154 Taxation 90.

<sup>834</sup> Vaines (n 833) 91.

<sup>835</sup> Vaines (n 833) 91.

or substantially a right to the full measure of equity which applies to ownership of ordinary shares.’<sup>836</sup>

Furthermore, a strong argument can be made that ordinary shareholders generally have no ‘right’ to income at all. In commenting on the Revenue’s position in Tax Bulletin 64 (now reflected in the Settlements Guide), Slevin correctly points out that there is at best merely a future expectation that dividends will be paid on ordinary shares.<sup>837</sup> Further, Slevin states that once the board of directors has lawfully resolved to make an interim dividend payment, this gives rise to a ‘right’ until the payment is made, but arguably even in this situation the directors would still have the power to rescind the resolution before the payment is made.<sup>838</sup> In any event, prior to the declaration of a dividend, either by the board or by resolution of the shareholders in the case of a final dividend, Mrs Jones has no ‘right’ to income at all, only a mere expectation that dividends will be received. This sort of expectation surely is distinguishable from the right referred to in section 660A(6). As Slevin concludes:<sup>839</sup>

‘Any reasonable interpretation of subsection 6(b) is that the right envisaged by the draftsman is an enduring right in existence at the time of the gift, as opposed to merely an expectation that a right to a dividend would arise.’

## (ii) Outright Gift Generally

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<sup>836</sup> Vaines (n 833) 92.

<sup>837</sup> Kevin Slevin, ‘Muddled Thinking’ (31 July 2003) 151 *Taxation* 477, 478.

<sup>838</sup> Slevin (n 837) 478.

<sup>839</sup> Slevin (n 837) 478.

The New Shorter Oxford Dictionary defines ‘giving’ as ‘the voluntary transference of property without anything in return’. Similarly, in *Berry v Warnett (Inspector of Taxes)*,<sup>840</sup> Buckley LJ thought that the ordinary primary meaning of ‘gift’ was ‘a voluntary transfer of property made without consideration’.<sup>841</sup>

In *Jones v Garnett*, Park J concluded that the arrangement involving Mr and Mrs Jones could not even be described properly as an ‘outright gift’ in the first place:<sup>842</sup>

‘There was far more comprised in [the] arrangement than would be covered by the expression “an outright gift”. Indeed, the arrangement did not even include an element which could, even taken in isolation, be regarded as an outright gift. Mr. Jones did not give to Mrs. Jones her share.’

Morrison C agreed with Park J’s reasoning and conclusion on this point,<sup>843</sup> but the Law Lords did not. Although this approach did not find favour in the House of Lords, it is a much stronger and more satisfactory conclusion than holding that Mrs Jones’s share was substantially a right to income as it is consistent with the established meaning of the word ‘gift’ as a voluntary transfer of property for no consideration. The provision at issue requires an outright gift from one spouse to another of property from which the settlement income arises. The property giving rise to the settlement income in this situation must be Mrs Jones’s share in Arctic. Mr Jones did not give Mrs Jones her share; she bought it from a third party. Therefore, a strong argument can be made that the

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<sup>840</sup> [1980] 3 All ER 798 (CA).

<sup>841</sup> *Berry v Warnett (Inspector of Taxes)* (n 840) 811. Buckley LJ was considering the meaning of the phrase ‘a gift in settlement’ in FA 1965 s 25(2).

<sup>842</sup> *Jones* (HC) (n 713) [44].

<sup>843</sup> *Jones* (CA) (n 713) [91]–[93].

exclusion should not apply. It appears to be going too far to conclude, as Special Commissioner Powell did, that an arrangement is an outright gift merely because it contains an element of bounty. Equating the broad concept of bounty with the much narrower expression ‘outright gift’ strains the meaning of that term.

Furthermore, Park J opined obiter in *Jones v Garnett* that even if Mr Jones had subscribed for both Arctic shares and then given one of the shares to his wife, this would still not constitute an outright gift under section 660A(6).<sup>844</sup> He considered a settlement that is itself an outright gift falls within the exclusion, but a settlement of which only one element is an outright gift does not. In his view, the exclusion was intended to apply to straight-forward cases where one spouse gives ordinary investment income-yielding property to the other, such as gifts of quoted shares yielding normal dividends, or tenanted property yielding rents, and not situations like that of Mr and Mrs Jones.<sup>845</sup>

Despite the logic of Park J’s approach, the House of Lords disagreed with Park J and the Court of Appeal, unanimously holding that the exception for outright gifts between spouses applied. Lord Hoffmann began his reasons on this point by noting that a gratuitous transfer of quoted shares from husband to wife, although obviously a settlement for the purposes of ICTA 1988 section 660A, is excluded from the section and

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<sup>844</sup> *Jones* (HC) (n 713) [45].

<sup>845</sup> *Jones* (HC) (n 713) [45].

the income is taxed as the wife's income.<sup>846</sup> He then considered the Revenue's arguments why this treatment did not apply in Mrs Jones's situation:<sup>847</sup>

'First, [the Revenue] say there was no gift of the share by Mr Jones to Mrs Jones. He never owned the share which she took. It belonged to the formation agents and Mrs Jones bought it from them for £1.

In my opinion this narrow analysis of the transaction would be inconsistent with the reasoning by which I think the transfer comes within section 660A in the first place. It was Mr Jones's consent to the transfer of a share with expectations of dividend to Mrs Jones for £1 which gave the transfer the "element of bounty" for the purposes of section 660A. By the same token, I think it made the transfer a 'gift' for the purposes of subsection (6). And there is no dispute that, if it was a gift, it was outright.'

Having rejected the Revenue's first line of argument, Lord Hoffmann continued:<sup>848</sup>

'The [Revenue's] second argument is that the transfer of the share was not the whole of the arrangement, which included the provision of services by Mr Jones, the dividend policy and so forth. Again, I think that would be inconsistent with the argument by which the Revenue have, in my opinion, succeeded on the first point. The transfer of the share was in my opinion the essence of the arrangement. The expectation of other future events gave that transfer the necessary element of bounty but the events themselves did not form part of the arrangement.'

Similarly, Lord Walker concluded:<sup>849</sup>

'...Arctic was the chosen vehicle through which Mr Jones was to offer his valuable services as an IT consultant, and it was an act of bounty on his part to permit his wife to acquire half its equity for the nominal sum of £1. In my opinion that amounted to an outright gift of the share within the meaning of section 660A(6). I respectfully disagree with Park J's contrary

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<sup>846</sup> *Jones* (HL) (n 713) [26].

<sup>847</sup> *Jones* (HL) (n 713) [27-28].

<sup>848</sup> *Jones* (HL) (n 713) [29].

<sup>849</sup> *Jones* (HL) (n 713) [55].

conclusion because I think he took too expansive a view of the scope of the statutory settlement.’

Lord Neuberger found Park J’s view ‘formidable’ but ultimately agreed with the other Lords – the reasons underlying the ‘bounty’ conclusion also support a finding that there was an ‘outright gift’:<sup>850</sup>

‘I see the force of [Park J’s] point, particularly as section 660A(6) is concerned with the question of whether the “settlement”, as opposed to the transfer of property comprised in the settlement, constituted an “outright gift”. However, it seems to me that the point wrongly detaches the bounty from the property, and that it contains an element of inconsistency, which is rather similar to the inconsistency in the proposition that, because the share was acquired for £1, it cannot be treated as a gift. The only reason that there is a settlement in the present case is that there is an arrangement involving the acquisition of a share which includes an element of “bounty”, as a result of what it is anticipated will happen following the acquisition of the share. In other words, the only reason that there is an “arrangement” is that the share acquired by Mrs Jones was, at the time of acquisition, worth more than she paid for it. I therefore find it difficult to see how one can detach the bounty from the property. The notion that there is a gift of the share arises because of what was anticipated, indeed what was intended, to happen in the future.’

### (iii) Conclusion on Outright Gift in the Family Business Context

In the case of a straight gift of ordinary shares from one spouse to another, the Revenue in the Settlements Guide argued that such a gift would not qualify for the outright gift exclusion where the shares could be said to be wholly or exclusively a right to income. The Revenue focused on the capital value of the shares, and whether the company involved had substantial assets. For reasons just discussed, this argument is weak when

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<sup>850</sup> *Jones* (HL) (n 713) [94].

ordinary shares are at issue, and the House of Lords decision in *Jones v Garnett* should put an end to this line of argument.

In other situations, however, the Revenue will be more successful on the outright gift issue, as was the case with the preference shares in *Young v Pearce*. In addition, in the post-*Jones v Garnett* special commissioner decision in *Buck*, Sir Stephen Oliver concluded that the husband's dividend waiver was not an outright gift to his then wife (the only other shareholder) both because the property given was wholly or substantially a right to income and also because the shares giving rise to the income were not transferred.<sup>851</sup>

'Section 660A(6) excludes an "outright gift" of property from one spouse to the other from the scope of the taxation of settlor provisions. That exclusion does not however apply where, as here, the property given is wholly or substantially a right to income: s 660A(6)(b). Here, income is diverted by means of a dividend waiver in anticipation of the declaration of a dividend. There is no "outright gift", merely a one-off waiver of any dividend that might be declared in respect of shares and the shares in question are retained by the previous person making the waiver and not given to the other spouse.

The exemption in s 660A(6) did apply in *Jones v Garnett* because, in contrast to the present situation, the essential arrangement identified in that case was the transfer of the share from the husband to the wife. It follows in my view that the present situation does not come within s 660A(6). There is no outright gift of property from which income arises.'

Although the House of Lords disagreed with Park J's view that there was far more going on in *Jones v Garnett* than a gift, Park J's conclusion accords well with the reasons underlying the control method of attribution of capital income (eg marriage neutrality,

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<sup>851</sup> *Buck v Revenue and Customs Commissioners* (n 793) [21]-[22].

privacy/autonomy, and because it can lead to a fairer distribution of assets between spouses) discussed at length in Chapter 4.<sup>852</sup> This approach also finds support in statements by the Inland Revenue and the Financial Secretary to the Treasury made around the time independent taxation of spouses was introduced in the late 1980s.<sup>853</sup> First, in a press release dated 14 March 1989, the Inland Revenue stated:<sup>854</sup>

‘The changes will ensure that when independent taxation begins in April 1990, income from a *simple* outright gift of assets between husband and wife...will be taxed as the income of the recipient and not as the income of the person making the gift.’ [emphasis added]

The use of the modifier ‘simple’ is consistent with Park J’s view that the exclusion was aimed at straight-forward spousal gifts, but, as discussed above, the Lords disagreed.<sup>855</sup> More importantly, Freedman and Schuz noted that in the debate on the independent taxation provisions of Finance Bill 1988, the Government was asked about the effect of existing anti-avoidance provisions on transfers and other arrangements between spouses designed to benefit from the new provisions.<sup>856</sup> In response, the Financial Secretary to the Treasury (Norman Lamont) stated:<sup>857</sup>

‘[W]here one partner in a married couple makes an outright gifts of assets to the other, our objective is that that should be recognized for tax purposes, and that the recipient and not the donor should be taxed on any income that arises from the assets after the transfer has occurred.... Independent taxation is bound to mean that some couples will transfer

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<sup>852</sup> See text at n 530.

<sup>853</sup> For a contrary view see Redston (n 683).

<sup>854</sup> Inland Revenue budget press release (n 681).

<sup>855</sup> Text beginning at n 846.

<sup>856</sup> Freedman and Schuz (n 80) 205.

<sup>857</sup> Standing Committee A (23 June 1988) col. 624.

assets between them with the result that their total tax bill will be reduced. This is an inevitable and acceptable consequence of taxing husbands and wives separately’.

Redston argues that the reallocation of assets between spouses in order to take advantage of one spouse’s personal allowances and lower rates of tax, was thus ‘not only contemplated, but accepted by the Government of the time’ and, furthermore, that ‘[t]here is no reason why this transfer of assets should not include shareholdings and partnership shares’.<sup>858</sup> It appears, however, that the Government at the time had not contemplated income-splitting arrangements other than those involving the simple gift of investment assets. Redston herself notes there is simply no mention in the Hansard debates or in the 1989 Inland Revenue press release of whether and how the exemption would apply in the case of a husband and wife small business.<sup>859</sup>

In commenting upon the Court of Appeal decision in *Jones v Garnett*, Tiley described the outright gift exclusion as a sensible exercise in line-drawing. He argued that once separate assessment was introduced, those drawing up the legislative changes had to choose how far spouses should be allowed to assign income between each other:<sup>860</sup>

‘The legislators could have decided to make all such assignments ineffective and treated all income arising from property transferred between the spouses as remaining with the original owner. They did not do so. They could not go to the other extreme and allow unrestricted assignment of income; that would have made a mockery of the tax system. To allow S1 to transfer, for example, earnings or dividends to S2, would simply have enabled taxpayers who were not minded to act on a commercial basis to rearrange their incomes to take the best advantage

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<sup>858</sup> Redston (n 683).

<sup>859</sup> Redston (n 683).

<sup>860</sup> Tiley (n 162) 299.

from the availability of personal allowances and lower ends of the progressive rate structure. The 1988 principles were after all based on separate taxation not aggregation followed by income splitting.’

Tiley described section 660A(6) as the resulting compromise; the transfer of assets is permitted to be effective for income tax purposes between spouses living together but it must be real.<sup>861</sup> This conclusion accords with the statements of Norman Lamont just cited and the general conclusions on attribution of capital income made in this thesis in Chapter 4. Tiley went on to argue that the language of the section, which avoids being over-prescriptive, requires the courts to draw the line – and they have done so (citing *Young v Pearce*<sup>862</sup>).<sup>863</sup> Nevertheless, this argument did not find favour in the House of Lords, and the law as it now stands post-*Jones v Garnett* is that once bounty has been established it will be difficult for the Revenue to argue that there has not been an outright gift where the shares at issue are ordinary shares. In other circumstances, such as with the preference shares in *Young v Pearce* and the dividend waiver in *Buck*,<sup>864</sup> it will be easier for the Revenue to argue that there was no outright gift.

Finally, although this point is not discussed in the reasons of the Special Commissioners or any of the judges in *Jones v Garnett*, it is interesting to note that the facts state that the dividends paid to Mr and Mrs Jones were deposited into the couple’s joint bank account.<sup>865</sup> Under section 626(4) of ITTOIA, a gift is not an outright gift for the purposes of section 626 if ‘(b) there are any circumstances in which the property, or

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<sup>861</sup> Tiley (n 162) 299.

<sup>862</sup> *Young v Pearce* (n 733).

<sup>863</sup> Tiley (n 162) 299.

<sup>864</sup> *Buck v Revenue and Customs Commissioners* (n 793) [21]-[22].

<sup>865</sup> *Jones* (SC) (n 718) [23].

any related property (i) is payable to the giver, (ii) is applicable for the benefit of the giver, or (iii) will, or may become, so payable or applicable'. Pursuant to sections 625(5) and 626(6), the dividends, as income from the property (ie the shares), would constitute related property. Similar wording is found in section 660A(6) of ICTA 1988. Since the dividends in *Jones v Garnett* were paid into a bank account in both Mr and Mrs Jones's name, an argument could be made that the dividend paid to Mrs Jones 'may become' applicable for the benefit of Mr Jones because he was able to withdraw the funds. In this event, the outright gift exception should not be available. However, since this argument was not considered by the commissioners or judges in the case it remains to be seen how broadly the courts will interpret what on their face appear to be words with a very broad scope indeed, should HMRC decide to take this point in the future.

#### **4. CONCLUSION**

Mr and Mrs Jones and other small business owners like them will not be happy with the continuing uncertainty in this area brought on by the Government's response to the House of Lords decision in favour of the Joneses. In the meantime, this form of family income splitting is able to continue, raising horizontal equity concerns for unincorporated business owners and employees. Moreover, the (completely understandable) pursuit of this and other tax benefits from incorporating will surely continue unnecessarily to complicate the lives of small business owners who otherwise would have carried on business in a much simpler unincorporated form.<sup>866</sup>

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<sup>866</sup> Freedman (n 650).

## **E. EMPLOYMENT-RELATED SECURITIES**

Finally, ITEPA section 447 levies an employment tax charge on ‘other chargeable benefits from securities’. The provision was introduced in response to avoidance schemes whereby executives were given shares in specially formed companies that then paid large dividends; these dividends were taxed much more lightly than employment earnings and were not subject to NICs.<sup>867</sup> Arguably, this section might apply in a family company income-splitting context as well.

A charge under section 447 arises where an ‘associated person’ receives a benefit in connection with ‘employment-related securities’, in which case the taxable amount determined under section 448 counts as employment income of the employee for the tax year in which the benefit is received. For this purpose, ITEPA section 421C defines ‘associated persons’ as the person who acquired the employment-related securities, (if different) the employee, and any ‘relevant linked person’. Pursuant to section 421C(2) a person is a ‘relevant linked person’ if that person (on the one hand), and either the person who acquired the employment-related securities or the employee (on the other), are or have been connected or are or have been members of the same household.

Formerly, section 447 did not apply if the benefit received was otherwise subject to income tax, ie under Schedule F. In 2005, however, section 447(4) was added to provide that the exclusion for benefits otherwise subject to income tax does not apply if ‘something has been done which affects the employment-related securities as part of a

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<sup>867</sup> David Cohen ‘When is a Dividend not a Dividend?’ [2006] BTR 7.

scheme or arrangement the main purpose (or one of the main purposes) of which is the avoidance of tax or national insurance contributions'. In some situations section 447 can be applied to recharacterise dividends as remuneration. The following example is provided in the HMRC guidance to Form 42:<sup>868</sup>

J Bloggs works for XYZ plc whose shares are listed on London Stock Exchange and on 1 July 2005 he was awarded 10,000 'B' shares in XYZ plc for no consideration. The 'B' shares entitle J Bloggs to receive £20,000 of special dividends on 1 December 2005, 2006 and 2007. The 'benefit' disclosed on Form 42, is £20,000 per year.

Thus, in this situation, the £20,000 dividends are recharacterised as remuneration and J Bloggs is taxed accordingly.

There is some disagreement amongst tax commentators as to whether section 447 as amended could apply to restrict income-splitting arrangements like that in *Jones v Garnett*.<sup>869</sup> The Professional Contractors Group has warned its members that the ambit of section 447 is 'ambiguous' and it could be 'wrongly used to attack legitimate small businesses'.<sup>870</sup> Cohen is uncertain as to whether the mere act of declaring a dividend on such shares would be caught.<sup>871</sup> Furthermore, Cohen notes that shortly after the amendment was introduced, Paymaster General Dawn Primarolo responded to concerns

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<sup>868</sup> HM Revenue & Customs, Form 42 (December 2006)  
<<http://www.hmrc.gov.uk/forms/form42.pdf>> accessed 14 June 2009.

<sup>869</sup> Nichola Ross Martin, 'A New Tax on Dividends – Revisited' (25 October 2006) AccountingWeb  
<<http://www.accountingweb.co.uk/cgi-bin/item.cgi?id=161179&d=1032&h=1019&f=1026/>>  
accessed 14 June 2009.

<sup>870</sup> Professional Contractors Group Limited, 'PCG Policy Briefing: Section 447' (2007)  
<[http://www.pcg.org.uk/cms/index.php?option=com\\_content&view=category&layout=blog&id=662&Itemid=1098](http://www.pcg.org.uk/cms/index.php?option=com_content&view=category&layout=blog&id=662&Itemid=1098)> accessed 14 June 2009, 1.

<sup>871</sup> Cohen (n 867) 7.

raised by the CIOT and others by providing assurances that the amended section 447 was aimed at complex and contrived avoidance schemes.<sup>872</sup>

Furthermore, Cohen as well as Thornhill argue that section 447 will not apply in any event in a *Jones v Garnett*-type situation because of the application of section 716A of ITEPA, which states that any income, so far as it falls with Part 2, 9 or 10 of ITEPA and ITTOIA Part 4 Chapter 3 ('dividends etc from UK resident companies') is to be dealt with under ITTOIA.<sup>873</sup> For this reason, Thornhill has described the amended section 447 as 'a damp squib'.<sup>874</sup> Others take a more cautious view. Hutton is of the opinion that the shares in a *Jones v Garnett*-type case would be employment-related securities, although he is sceptical as to whether one or even a series of dividends does 'affect' the shares.<sup>875</sup> In any event, Hutton believes that HMRC do wish to apply NICs to all dividends on shares owned by employees who receive less than a 'market value' salary and so would not find it surprising if there were further amendments to section 447.<sup>876</sup>

Assuming that the dividends in a *Jones v Garnett*-type situation could be recharacterised as remuneration, the next question is who would be taxable on the additional remuneration? There is not much doubt that Mr Jones would be taxed on the dividend payments made to him, but what of the dividends paid to Mrs Jones? Would

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<sup>872</sup> Ross Martin (n 869).

<sup>873</sup> Cohen (n 867) 8.

<sup>874</sup> Ross Martin (n 869). See also Nichola Ross Martin, 'Sleepless in Securities: Employment-related Securities' (13 July 2006) Taxation 410.

<sup>875</sup> Matthew Hutton, 'Capital Tax Review' (October 2005) *Dcode Online* <<http://www.dcode.co.uk/site/home/20051122settlements.html>> accessed 20 July 2006.

<sup>876</sup> Hutton (n 875).

they be recharacterised as her additional remuneration or his? Section 447(1) on its face applies to ‘associated persons’, which as noted above includes the employee (Mr Jones) as well as connected persons or members of his household, either of which tests would catch Mrs Jones. This seems to permit Mrs Jones’s dividends to be taxed as additional remuneration of Mr Jones. As mentioned in Chapter 4, the benefit-in-kind rules, such as ITEPA section 201, can apply to tax an employee on payments and other benefits provided to the employee’s family.<sup>877</sup> For example, assume a family company provided a car to the spouse of the company’s director and no benefit in kind charge arose because the spouse’s earnings were below £8,500 (calculated so as to take into account the car benefit). According to Deek, in such a case it is not unknown for the Revenue either to argue that such a benefit is not ‘wholly and exclusively’ for the company’s trade or that it is a car provided to a member of the director’s household by virtue of his or her employment, with the result that the car benefit would be taxed as remuneration of the director.<sup>878</sup>

## F. CONCLUSION

This Chapter considered how the UK tax regime currently deals with income-splitting arrangements in the context of family businesses. The UK tax authorities rely primarily, and not entirely successfully, on the ‘wholly and exclusively’ test and the settlements legislation. Although there are few decided cases on the application of the ‘wholly and exclusively’ test to family income-splitting arrangements, cases such as *Copeman v*

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<sup>877</sup> Text at n 517.

<sup>878</sup> Deek (n 646) 18.

*Flood* illustrate that the test places some restrictions on extreme forms of income splitting involving the payment of above-market value remuneration to family members. Notably, although it is a test of general application to all types of business expenses, and is not detailed or particularly certain as to its application, it is a well-established part of the tax landscape. The ‘wholly and exclusively’ test cannot be a complete solution, however, as it does not apply to more sophisticated income-splitting arrangements involving the payment of below-market salaries (as opposed to excessively-high compensation) or to payments that are not deductible in computing business profits in any event, such as dividends.

Furthermore, attempting to address income splitting through family partnerships by challenging the validity of the partnership is not likely to be effective for the UK tax authorities except in the most egregious of cases involving minor children. The settlements provisions have some teeth, particularly in relation to income-splitting arrangements involving minor children, spousal dividend waivers, or where spouses are given preferred shares in a family company, but, as evidenced by the result in *Jones v Garnett*, will not be effective in other situations where one spouse appears to be receiving a greater share of the business profits in the form of dividends on ordinary shares than might be warranted by his or her relative contribution to the business. In addition, the settlements provisions do not address the tax arbitrage advantages from converting highly-taxed labour income into lower-taxed capital income. As a result, Mr Jones is able to convert a portion of his labour income into capital income, and moreover, a portion of that income can then be shifted to Mrs Jones. This result undermines the policy grounds behind the choice of the individual as tax unit as well as the income attribution principles

established in the previous Chapters. The provisions also lack a reasonability or arm's length principle component upon which to ground an appropriate assessment of the quantum of bounty in cases involving joint but unequal contributions to the business. Finally, ITEPA section 447 may apply in situations like that in *Jones v Garnett*, although to-date that provision has not been so-utilised.

Where can the UK tax system go from here? Possible reforms, some minor and some fundamental, are discussed in the next Chapter.

## **CHAPTER SIX: OPTIONS FOR REFORM**

### **A. INTRODUCTION**

Arriving at a suitable solution to the challenges posed by income-splitting arrangements involving family businesses is not an easy task for tax policy makers, and it is not surprising that the UK Government so far has been unable to come up with a workable solution. This Chapter puts forth a number of possible approaches, ranging from doing nothing at all to major structural reform to the taxation of small businesses, which alone or in combination could provide at least part of the elusive answer.

Part B begins by discussing whether any change is necessary or if the status quo as described in the preceding Chapters is satisfactory. Part C evaluates the merits of new legislation, either in the form of amendments to the existing rules or through the introduction of an entirely new statutory regime. Part D considers expanding the scope of the employment tax regime as a means of restricting the ability of some taxpayers to engage in business income splitting.

Part E analyses more radical options available for reforming the UK tax system. It begins by considering why it is that the tax system encourages someone like Mr Jones to incorporate and take most of his remuneration in the form of dividends rather than salary. Even if Mr Jones had had to pay tax on the dividends paid by Arctic to Mrs Jones, this is still a much better result from both an income tax and NIC perspective compared with drawing a salary. Reforms to better align the tax and NIC treatment of employees,

incorporated and unincorporated businesses would reduce these incentives and limit the benefits to be had from entering into income-splitting arrangements. Part F examines whether tax avoidance approaches could provide a satisfactory solution. Part G concludes.

## **B. DO NOTHING**

The easiest option, and the option that the UK tax authorities have ended up taking to this point, is to do nothing. The status quo has its supporters. Redston argues that placing income splitting under a microscope ‘is likely to cause disproportionate complexity and uncertainty for small family businesses’.<sup>879</sup> She concludes that a ‘Nelsonian approach’ is the best approach: ‘the Government should therefore pick up its telescope and then turn a blind eye.’<sup>880</sup> There is some merit in Redston’s position, especially given the rapid pace of growth and change in UK tax legislation discussed in Chapter 2.<sup>881</sup> It will be recalled from that discussion that according to Raz one of the more important principles that can be derived from the basic idea of the rule of law is that laws should be relatively stable. Stability is important because people need to know the law not only for short-term decisions but also for long-term planning. The Meade Committee and Shaw, Slemrod and Whiting have argued that stability is a highly desirable feature of a tax system given the

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<sup>879</sup> Redston (n 62) 686.

<sup>880</sup> Redston (n 62) 686. Redston’s reference to Nelson is a reference to the origin of the idiom ‘turn a blind eye’, meaning to ignore unpopular facts or orders. Admiral Nelson was blinded in one eye early in his Royal Navy career. During the Battle of Copenhagen in 1801, Nelson ignored orders to cease action by putting his telescope to his blind eye and claiming he could not see the signal: see BBC, ‘Horatio Nelson’ <[http://www.bbc.co.uk/history/historic\\_figures/nelson\\_horatio.shtml](http://www.bbc.co.uk/history/historic_figures/nelson_horatio.shtml)> accessed 30 April 2009.

<sup>881</sup> See text beginning at n 128.

substantial compliance costs change involves. These stability arguments must be balanced against the uncertainty that continues to exist in the application of the settlements provisions in the family business context. But is doing nothing a realistic option for the UK Government?

Chapter 3 examined the question of whether the UK's choice of the individual as the tax unit was appropriate and concluded that it was; there is no need to undertake fundamental reform in this area, such as returning to the pre-1990 system in which a wife's income was added to her husband's and taxed as his. There is a case for a more functionally-based approach to tax legislation, however, which might mean rethinking provisions based on marriage/civil partnership to the exclusion of other relationships such as cohabiting unmarried couples. Chapter 4 considered whether the control principle was the appropriate choice for attributing income (both capital and labour) to the tax unit and again concluded that for the most part it was, although there is some difficulty applying this principle in practice under the current rules where income is produced by the joint effort of related parties, such as in a family partnership or company. Chapter 5 demonstrated that the primary UK rules addressing income splitting in family businesses (eg challenging the validity of partnerships, the 'wholly and exclusively' test for deductibility of salaries and the settlements legislation) place some limitations on the ability of families to engage in more extreme forms of income splitting (such as paying excessive compensation to spouses and children) despite some inherent uncertainty as to their application in specific situations.

It also must be emphasised that the result in *Jones v Garnett* was not a complete disaster for HMRC by any means. The House of Lords accepted a broad interpretation of ‘arrangement’ and the common law bounty requirement does not appear to be a particularly difficult hurdle for HMRC to overcome as long as the arrangement at issue would not have been entered into by parties dealing at arm’s length. The Special Commissioner decision in *Buck* appears to widen the scope of ‘arrangement’ even further since in that case the mere waiver of a dividend in two years by a taxpayer was enough to constitute a bounteous arrangement.<sup>882</sup>

Furthermore, the outright gift carve-out in the settlements provisions is somewhat limited, applying as it does only to gifts between spouses and civil partners and not to arrangements involving other family members (especially minor children) or cohabiting unmarried couples or even spouses in cases where preferred shares are involved. In addition, for the reasons discussed earlier,<sup>883</sup> it may well be that the outright gift exception will be further restricted when a court comes to consider fully the additional limitation in section 626(4) of ITTOIA concerning gifted property or related property that will, or may, become payable or applicable to the donor. It remains to be seen, for example, whether in a future case the courts will look more closely at the destination of income from an alleged settlement. If, as in *Jones v Garnett*, the dividends are paid into a joint bank account, or otherwise used in a way that benefits the settlor, a court may decide that that arrangement will not qualify for the outright gift exception.

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<sup>882</sup> *Buck v Revenue and Customs Commissioners* (n 793) 6-7.

<sup>883</sup> See text above at n 865.

Finally, in future cases the courts may construe the ‘outright gift’ exception more narrowly than is presently the case for other reasons. In one of the few cases since *Jones v Garnett*, the Special Commissioner in *Buck* concluded that a one-off waiver of any dividend that might be declared in respect of shares where the shares in question are retained by the person making the waiver and not given to the other spouse (unlike the situation in *Jones v Garnett*) did not qualify as an outright gift.<sup>884</sup> The House of Lords may in the future have the opportunity to revisit whether a situation like *Jones v Garnett* should fall within the outright gift exception, given that the income at issue is derived, at least to a significant degree, from the ongoing labour of the settlor. If the policy behind the outright gift exception is to exempt genuine transfers of assets between spouses—in keeping with the control theory of income attribution discussed in Chapter 4—an ongoing transfer of earnings from a settlor that constitute to a large part labour income under his control should not, as a matter of principle, so qualify. The reasoning of Park J in *Jones v Garnett* is commendable in this regard.<sup>885</sup>

In summary, doing nothing may, given enough time and more cases, prove to be an acceptable strategy for the UK Government. Although the settlements legislation has been around since the 1930s, it is still comparatively early days in terms of how these rules apply or do not apply in the family business context. The continuing uncertainty as to if and how these rules apply as they currently stand is not especially desirable, but much has already been learned from a relatively few number of cases. In time even more

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<sup>884</sup> *Buck v Revenue and Customs Commissioners* (n 793) 9-10.

<sup>885</sup> Text beginning after n 850.

cases will find their way to the courts, and more fact patterns will be available to help tease out the application of the settlements provision in the family business context.

As the law presently stands, however, doing nothing is not the best choice from a tax policy standpoint. Why should the UK tax authorities be content with a situation in which they are able to restrict some forms of income-splitting arrangements involving family businesses but not other forms? Such a situation is far from ideal on policy grounds. The inability to effectively deal with the transfer pricing issue for jointly-produced business income, as exemplified by *Jones v Garnett*, is the most glaring weakness in the present state of the law. HMRC is unable to effectively challenge situations where one spouse (eg Mrs Jones) appears to be receiving a greater share of the business profits than might be warranted by her relative contribution to the business. This situation allows taxpayers to self-select out of the individual tax unit and the control model of income attribution, undermining both and reducing the tax take in the process.

Deeper structural issues exist as well. Neutrality between business forms is the most obvious. Doing nothing leaves incentives in place that encourage taxpayers to incorporate rather than carry on activities as employees in search of lower taxes generally as well as the income-splitting advantages. This result also violates the principle of horizontal equity. Finally, again for horizontal equity reasons, the settlements legislation ideally should not apply to married spouses differently (more or less harshly) than to similarly-situated unmarried cohabitants. Recently, other UK anti-avoidance rules (such as the managed service company rules) target both married and unmarried cohabitants

living together as husband and wife. This is a commendable development given the increasing number of unmarried cohabitants as discussed in Chapter 3.<sup>886</sup>

## C. NEW INCOME-SPLITTING LEGISLATION

If something indeed does need to be done—as appears to be the case—the simplest and most obvious option for reforming the law in this area is to introduce new statutory provisions to explicitly target the mischief of income-splitting arrangements like that in *Jones v Garnett* that are otherwise not caught by the settlements legislation or other tools such as challenges to the validity of partnerships and the ‘wholly and exclusively’ test. Such new legislation could take the form of amendments or additions to the settlements legislation or, alternatively, an entirely new legislative code (as the Government initially preferred) could be introduced. This latter option is considered first.

### 1. A NEW LEGISLATIVE SCHEME

Oliver and Harris argue that the settlements provisions are looking ‘substantially archaic’ in the current services era,<sup>887</sup> and that if income splitting in family businesses is not to be tolerated ‘as a bare minimum...it is time the settlement provisions were morphed into something more fit for purpose’.<sup>888</sup> The UK Government’s 2007 proposals to do just that are considered next.

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<sup>886</sup> See text at n 229.

<sup>887</sup> Oliver and Harris (n 145) 285.

<sup>888</sup> Oliver and Harris (n 145) 287.

### (a) The 2007 Proposals

Following quickly on the heels of the taxpayer's victory in *Jones v Garnett*, the UK Government elected to pursue the implementation of a new legislative regime. The Government announced in the October 2007 Pre-Budget Report that it intended to launch a consultation on draft legislation to prevent income shifting through partnerships and companies, and aimed to have this new legislative regime take effect from April 2008.<sup>889</sup> It took until December 2007, however, before a joint HM Treasury / HMRC consultation document on income shifting<sup>890</sup> was released, leaving only a very short consultation window. The consultation document included illustrative draft legislation<sup>891</sup> specifically targeting income shifting through family businesses—not just companies but partnerships as well. As the legislation was principle-based rather than detailed, it also included extensive draft guidance—albeit with fairly simplistic examples<sup>892</sup>—on how the legislation would work.<sup>893</sup> The Government's proposals, however, were heavily criticised by organisations such as the Tax Faculty of the Institute of Chartered Accountants in

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<sup>889</sup> HM Treasury, '2007 Pre-Budget Report and Comprehensive Spending Review' (n 724) [5.99]-[5.100].

<sup>890</sup> HM Treasury and HM Revenue & Customs, 'Income Shifting: A Consultation on Draft Legislation' (December 2007) <[http://www.hm-reasury.gov.uk/consultations\\_and\\_legislation/income\\_shifting/consult\\_income\\_shifting.cfm](http://www.hm-reasury.gov.uk/consultations_and_legislation/income_shifting/consult_income_shifting.cfm)> accessed 27 March 2008.

<sup>891</sup> HM Treasury and HM Revenue & Customs, 'Income Shifting: A Consultation on Draft Legislation' (n 890) Annex A.

<sup>892</sup> HM Treasury and HM Revenue & Customs, 'Income Shifting: A Consultation on Draft Legislation' (n 890) Annex B.

<sup>893</sup> HM Treasury and HM Revenue & Customs, 'Income Shifting: A Consultation on Draft Legislation' (n 890) Annex C.

England and Wales<sup>894</sup> and the CIOT<sup>895</sup> for reasons that will be discussed shortly. As a result, in the 2008 Budget Report the Government announced it would delay implementation of any new income shifting legislation until the 2009 Finance Bill to allow for further consultation on its proposals.<sup>896</sup> As mentioned in the Introduction to this thesis, the November 2008 Pre-Budget Report put the process on hold indefinitely, and this remains the position following the March 2009 Budget.

Although the Government's legislative proposals have been withdrawn, they provide a useful example of how a new legislative approach can operate, the mischief that the Government aimed to tackle, and the issues that arise. For those reasons, the proposals will be examined next in some detail. The main thrust of the proposals was as follows:<sup>897</sup> where income is shifted from one individual ('Individual 1') to another ('Individual 2')<sup>898</sup> the shifted income is to be treated for the purposes of income tax as forming part of the income of Individual 1 and not Individual 2 for the relevant tax year.<sup>899</sup> In this respect, the proposals follow a similar approach to that of the settlements legislation, though some differences in the details are readily apparent, most notably in the scope of the new code and the new definitions introduced. In terms of scope, the regime applied only to shifted income consisting of distributions of a company or

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<sup>894</sup> Tax Faculty of the Institute of Chartered Accountants in England and Wales, 'Income Shifting: A Consultation on Draft Legislation' (19 February 2008) Taxrep 17/08 <<http://www.icaew.com/index.cfm?route=154639>> accessed 27 March 2008.

<sup>895</sup> Chartered Institute of Taxation (n 148) ('The legislation would be unworkable and have no semblance of practicality or certainty': [2.1]).

<sup>896</sup> HM Treasury, 'Budget 2008' (n 3) [4.69].

<sup>897</sup> Proposed draft Chapter A1 of ITA 2007, comprising ss 681A-F.

<sup>898</sup> Proposed ITA 2007 s 681B(1).

<sup>899</sup> Proposed ITA 2007 s 681C(1).

partnership profits ('Condition D'),<sup>900</sup> and only where more combined income tax was payable by Individual 1 and 2 as a result of the application of these rules (eg the rules could not be used to generate combined tax savings through the shifting of losses).<sup>901</sup> Importantly, income was considered to be shifted when three additional conditions (Conditions A, B and C) were satisfied.<sup>902</sup>

Pursuant to Condition A, Individual 1 must be a party to 'relevant arrangements', or have the power to control or influence relevant arrangements.<sup>903</sup> Arrangements are 'relevant arrangements' if the arrangements are not genuine commercial arrangements and it would be reasonable to draw the conclusion, from all the circumstances of the case, that the purpose, or one of the main purposes, of the arrangements is the avoidance or reduction of charge to income tax.<sup>904</sup> Thus, the bounty requirement in the settlements legislation was eschewed in favour of a 'genuine commercial arrangement' combined with a tax avoidance motivation test. Arrangements are genuine commercial arrangements only where the arrangements are effected in the course of a trade or business and for its purpose, or with a view to setting up and commencing a trade or business and for its purpose.<sup>905</sup> In addition, the arrangement must not be on terms other than those that would have been made between persons not connected with each other

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<sup>900</sup> Proposed ITA 2007 s 681B(6).

<sup>901</sup> Proposed ITA 2007 s 681D(1).

<sup>902</sup> Proposed ITA 2007 s 681B(2).

<sup>903</sup> Proposed ITA 2007 s 681B(3).

<sup>904</sup> Proposed ITA 2007 s 681E(1).

<sup>905</sup> Proposed ITA 2007 s 681E(3).

dealing at arm's length or such as would not have been entered into between such persons so dealing.<sup>906</sup>

Requiring a tax avoidance purpose along with a commerciality test does not seem to add much to the common law bounty test. Lord Hoffmann's formulation of the test in *Jones v Garnett* was that the general effect of the cases is that the settlor must provide a benefit under the arrangement which would not have been provided in a transaction at arm's length.<sup>907</sup> It is the tax-motivated, family income-splitting purpose that gives rise to the uncommercial (or bounteous) features of the arrangement like that in *Jones v Garnett*. Although the courts have given the term 'arrangement' in the settlements provision a broad scope, as confirmed by Lord Hoffmann and Lord Walker in *Jones v Garnett*,<sup>908</sup> interestingly, perhaps to avoid any doubts of the kind raised by Baroness Hale and Morritt C in that case,<sup>909</sup> the term 'arrangements' was given its own definition for the purpose of the income-shifting rules; it includes 'any agreement, understanding, scheme, transaction or series of transactions (*whether or not legally enforceable*)' (emphasis added).<sup>910</sup>

The second condition (Condition B) required that pursuant to the relevant arrangements Individual 1 forgoes income and any of the foregone income, or any income (directly or indirectly) deriving from or otherwise representing any of the

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<sup>906</sup> Proposed ITA 2007 s 681E(5).

<sup>907</sup> Chapter 5, text at n 753.

<sup>908</sup> Chapter 5, text beginning at n 742.

<sup>909</sup> Chapter 5, text at n 766 and n 782.

<sup>910</sup> Proposed ITA 2007 s 681E(6).

foregone income, would be income of Individual 2 ('the shifted income') for a tax year ('the relevant tax year').<sup>911</sup> Income is 'foregone income' for this purpose if (a) Individual 1 is (or apart from the relevant arrangements would be) entitled to receive the income but does not receive it, or (b) having regard to any work done by Individual 1 and all other relevant circumstances, Individual 1 might reasonably be expected to receive the income but does not do so.<sup>912</sup> Thus, the work done by Individual 1 is the key determinant (as opposed to the relative work and contributions of Individuals 1 and 2), although the provision does allow HMRC to take into account not only the activities of Individual 1 but 'all other relevant circumstances'.

Finally, under Condition C, Individual 1 must have the power to control or influence the amount of the shifted income.<sup>913</sup>

Thus, in summary, if Individual 1 has the power/influence to forego dividends or partnership profits that would otherwise come to him and instead shifts the income to Individual 2 other than on a commercial, arm's length basis in order to avoid/reduce income tax, any shifted income will be taxed in Individual 1's hands and not Individual 2's.

## (b) Commentary on the 2007 Proposals

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<sup>911</sup> Proposed ITA 2007 s 681B(4).

<sup>912</sup> Proposed ITA 2007 s 681F(1).

<sup>913</sup> Proposed ITA 2007 s 681B(5).

As mentioned at the outset, the Government's income shifting proposals were met with heavy criticism, and deservedly so. The first major problem with the draft regime was the 'general commercial arrangements' requirement in draft ITA 2007 section 681E(2). The draft guidance stated that this rule is designed to ensure that the legislation does not apply to arrangements that are made on terms that would have been made by individuals acting on an arm's length basis; that is, to arrangements that 'are the same as those that the individual would have been willing to undertake with an unconnected third party'.<sup>914</sup>

In theory, and as advocated in Chapter 4 of this thesis, the arm's length principle is an appropriate basis for attributing income from joint business activity to the family members responsible for generating that income. Furthermore, supporters of principle-based drafting contend that a fairly short, broadly-drafted legislative regime resting on a foundation of detailed HMRC guidance can be a legitimate and effective approach so long as the administrative guidance adheres to clear principles set out by Parliament.<sup>915</sup> However, the examples provided in the consultation document were very simplistic, assuming, for example, that a spouse has 'no role' in the other spouse's business.<sup>916</sup> It is

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<sup>914</sup> HM Treasury and HM Revenue & Customs, 'Income Shifting: A Consultation on Draft Legislation' (n 890) Annex B, [B.20].

<sup>915</sup> John Avery Jones (n 138); Lord Howe of Aberavon, 'Simplicity and Stability: the Politics of Tax Policy' [2001] BTR 113; John Braithwaite, 'Rules and Principles: A Theory of Legal Certainty' (2002) 27 *Austl J of Leg Phil* 47; Freedman (n 102); Richard Krever, 'Plain English Drafting, Purposive Drafting, Principle-based Drafting: Does Any of it Matter?' in Judith Freedman (ed), *Beyond Boundaries: Developing Approaches to Tax Avoidance and Risk Management* (Oxford University Centre for Business Taxation, Oxford 2008) 189; Tracey Bowler, *Countering Tax Avoidance in the UK: Which Way Forward?* Tax Law Review Committee Discussion Paper No 7 (The Institute for Fiscal Studies, London 2009) 41-47. For a contrary view see John Prebble, 'Should Tax Legislation Be Written from a Principles and Purpose Point of View?' [1998] BTR 112.

<sup>916</sup> HM Treasury and HM Revenue & Customs, 'Income Shifting: A Consultation on Draft Legislation' (n 890) Box 1.1 (example with Nina and Charlie).

not difficult to design rules to cover such bright-line situations, but the contributions (financial, administrative, technical, strategic, assumed risks) that one family member makes to another's business is much more likely to fall somewhere along a spectrum from little involvement to heavily involved. The operation of the 'genuine commercial arrangements' test is more difficult to apply outside the straightforward examples provided in the consultation document. The failure of the Government to recognise this and attempt to deal with it head on undoubtedly undermined their efforts.

Moreover, the CIOT argued in its consultation response that if family business persons are willing to put in the necessary time and effort, it may have been quite easy to satisfy the commerciality test since the costs involved in hiring a third-party to perform even a little work at odd times (such as weekends and holidays) for the business would be high:<sup>917</sup>

'We think that, if most OMBs [Owner-Managed Businesses] applied an arm's length test to everything that was done by family members, in many instances there would be no money left to distribute to the shareholders because the cost of buying in premises, unclaimed expenses and family expertise would often exhaust the income. Hence, many owners could theoretically extract more from the business rather than less if on an arm's length basis. We think this would extend to many of the people HMRC probably see as having income shifted to them. After all, what is an arm's length reward for the general assistance and support given at irregular times of the day by an individual who can deliver effectively and efficiently largely because of a lengthy association with and knowledge of the business and the others(s) involved?'

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<sup>917</sup> Chartered Institute of Taxation (n 148) [5.3.7]. See also Redston (n 62) 683-85 and Crawford and Freedman (n 94) [III.3.2].

The CIOT also noted that it was necessary to justify only the amount of any shifted income taxed below the higher rate, not the entire amount, thus making it even easier for taxpayers to satisfy. Finally, the CIOT argued that it was unreasonable to require family members to evaluate the commerciality of arrangements between them to the degree required by the proposed legislation, even if reasonable comparatives were available, as family relationships are not by their nature commercial, especially in how income is distributed.<sup>918</sup> These proposals would have required a considerable amount of time and effort on the part of many family business persons merely to be able to demonstrate that the regime, in fact, did not apply to them in a given tax year.<sup>919</sup>

The CIOT's criticisms were generally valid, but the main problem with the proposals was not their reliance on the arm's length principle, but rather how the principle was implemented. The scheme focused too heavily on the work done by Individual 1 rather than the *relative* work and contributions of both Individuals 1 and 2 (and others).<sup>920</sup> Directing the focus on Individual 1 may be appropriate in some cases when the contribution by Individual 2 is minimal and directly comparable to services that could have been provided by non-family members. In many other situations, however, the income generated by the business is the joint product of the contributions (even if unequal) of more than one individual. Moreover, as a result of focusing the legislative proposals on Individual 1, the HMRC examples included with the guidance adopted a comparable uncontrolled price (CUP) approach (which attempts to compare prices for

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<sup>918</sup> Chartered Institute of Taxation (n 148) [5.3].

<sup>919</sup> Chartered Institute of Taxation (n 148) [5.3.9].

<sup>920</sup> Chartered Institute of Taxation (n 149) [2.6]

services in a situation involving associated entities with prices charged between independent entities in comparable circumstances), determining comparables for the less active spouse in a husband and wife business. This left HMRC open to the criticisms raised by the CIOT in the quotation above that it either would be difficult to find appropriate comparables or, if comparables were found, it would be easy to satisfy a comparability analysis. Instead, HMRC should have recognised that whilst a CUP approach may be appropriate in those (few) cases where a family member is providing minimal services directly comparable to that that could be provided by a third party<sup>921</sup> a more appropriate way of implementing the arm's length principle is to determine a reasonable attribution of profits to each family member based on their relative contributions to the joint undertaking using a profit-split approach (as discussed in Chapter 4).<sup>922</sup>

In addition, the CIOT,<sup>923</sup> Redston,<sup>924</sup> Gammie<sup>925</sup> and others argued that this type of legislative response imposes an unacceptable and unnecessary level of uncertainty and complexity for small business owners who must self-assess their income tax liability and may not have the resources to pay for professional advice. These are very important considerations; however, these concerns can be overblown. For example, if in applying the proposals a question arises as to whether someone is drawing a below market-salary, this will obviously require a determination as to what a market-level salary will be in the

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<sup>921</sup> As described in Chapter 4; see text at n 596.

<sup>922</sup> Text beginning at n 597.

<sup>923</sup> Chartered Institute of Taxation (n 148) [5.3.9].

<sup>924</sup> Redston (n 62) 681.

<sup>925</sup> Gammie (n 61) 691.

particular situation, and this determination necessarily involves some uncertainty and judgment. However, the ‘wholly and exclusively’ test discussed in Chapter 5 raises similar issues but no one is suggesting that that test is too uncertain or too arbitrary to apply. Is it much more difficult to determine if someone is being paid too low a salary as compared to too high a salary? Whilst we may not know for certain whether a reasonable salary for someone like Mr Jones is £60,000 or £70,000, one can feel pretty comfortable that it is not £7,000.

Admittedly, the analysis becomes more difficult in situations further away from the personal services business end of the spectrum. Where the business is more capital-intensive or is an unlimited partnership, where the partners can reasonably expect an appropriate level of compensation for the risk they are undertaking as well as for the number of hours spent working for the business of the partnership, a more sophisticated transfer pricing analysis may be required when dividends are to be distributed or partnership profits allocated, or at the time of self-assessment. As these are infrequent and significant times and events for the business and its shareholders, this may not place too great a compliance burden on those businesses. Certainly the burden would be far less than, for example, subjecting these businesses to the full extent of the UK domestic transfer pricing regime (from which most are currently exempt).<sup>926</sup> As discussed in Chapter 4, a transfer pricing analysis may give rise to more than one possible result, but that does not mean that it is therefore too uncertain, too complex, or too burdensome to

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<sup>926</sup> ITCA 1988 Sch 28AA para 5B-5E.

be workable in practice.<sup>927</sup> Nevertheless, the uncertainty and complexity of this option raises legitimate concerns and some compromise between equity/neutrality, on the one hand, and certainty/ease of administration, on the other hand, is probably inevitable.

The second major problem with the proposed and then withdrawn legislation was that it was poorly targeted, and its ambit too wide. The draft rules applied in the same way to arrangements between spouses, unmarried partners, siblings, adult children, parents, cousins, aunts and uncles, and close friends—anyone potentially dealing otherwise than at arm’s length. It seems unlikely that there is a significant amount of taxpayers shifting income to cousins, aunts and uncles in search of combined tax savings, and it was overly ambitious to draw up income-splitting rules to cover such a broad spectrum of relationships. The settlements provisions, on the other hand, are much more focused. They apply most strictly where there is the greatest risk of tax-motivated income splitting, ie with spouses and minor children. In other situations the provisions apply only where the relevant settlor has an *actual* interest in the settled property. This requires the people involved to be financially interdependent in actual fact. When spouses or civil partners are involved, and the likelihood of some degree of financial interdependence already high, the scope of the settlements provisions is at first broad because spouses are deemed by the legislation to have an interest in each other’s property. This scope is progressively narrowed, however, first by the common law ‘bounty’ requirement, and then by the exception for outright gifts to spouses. As already mentioned, these

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<sup>927</sup> See text at n 579.

arguments support extending the settlements provisions to some unmarried cohabitants as well as married spouses.

In summary, the 2007 proposals to address income-splitting were fundamentally flawed and not fit for their intended purpose. A more preferable legislative solution to the 2007 proposal is to expressly provide a mechanism in the settlements provisions to allow the application of the arm's length principle or a reasonableness test (as advocated in Chapter 4) to the relative contributions of the spouses in order to arrive at the appropriate quantum of bounty having regard to all the circumstances. This approach allows a spouse like Mrs Jones an adequate return on her capital invested (which may be minimal) but more importantly also allows her to share in the profits of the joint business activity to an extent commensurate with her contribution to the business (likely less than a 50-50 share in the Jones's situation). This option is considered next.

## **2. AMEND THE SETTLEMENTS LEGISLATION**

Rather than creating an entirely new legislative regime to address income splitting in family businesses, the Government could simply amend the existing settlements provisions to better target the mischief it wants to stop. This less ambitious approach has several advantages. First, for the reasons just discussed, the settlements provisions are fairly well targeted. To the extent that 'unacceptable' income-shifting is taking place within family businesses, it seems much more likely to involve spouses and minor children than more distant relations. The settlements provisions are much more focused in this regard. Moreover, while HMRC was unsuccessful in its attempts to use the

settlements provisions in *Jones v Garnett*,<sup>928</sup> these rules have been applied successfully to nullify other income-splitting arrangements, including in *Young v Pearce* where dividends had been paid on preference shares held by the taxpayers' wives,<sup>929</sup> and most recently in *Buck* where the husband had waived his entitlement to dividends so that large dividends could be paid to his wife.<sup>930</sup> As set out above in the 'do nothing' option, these rules are not perfect but they clearly do have teeth.

Second, because the relevant settlements provisions have been around for nearly 70 years, there is already a well-established, and growing, body of cases on issues such as the meaning of 'settlement', 'arrangement', 'settlor', and 'wholly or substantially a right to income' generally, as well as the common-law 'bounty' requirement. Moreover, even though the application of the settlements provisions in the family business context is a fairly recent development there is already a reasonably well-developed body of cases, including cases on the operation of the 'outright gift' exception for spouses. As the Meade Committee and others have noted, there is an element of truth in the adage that 'an old tax is a good tax'.<sup>931</sup> Taxpayers and their advisors have had time to get familiar with the general operation and scope of the settlements provisions. The 2007 draft proposals, on the other hand, introduced new concepts such as 'influences', 'genuine commercial arrangements' and a new definition of 'arrangement'; the meanings of these terms are much less certain and some interpretative guidance from the courts would have

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<sup>928</sup> *Jones* (HL) (n 713).

<sup>929</sup> *Young v Pearce* (n 733).

<sup>930</sup> *Buck v Revenue and Customs Commissioners* (n 793).

<sup>931</sup> Meade Report (n 13) 13. See also the discussion on complexity and stability beginning at n 127.

been required. Instead of designing an entirely new regime, with new definitions and tests that will take years to find their ways to the court for additional guidance, the settlements provisions could be left mostly as they are with only relatively minor fine tuning.

In the event that it was thought necessary for some amendments to the settlements legislation—to clarify or also to expand their current ambit—what could be done? As it now seems clear that ‘arrangement’ and thus ‘settlement’ have broad meanings, the settlements provisions are capable of restricting income-splitting arrangements involving family members other than spouses where the settlor retains an actual interest in the settled property. Some fine tuning of the provisions as they relate to spouses is required, however, because spouses are automatically deemed to have an interest in the other spouse’s property, which makes the definition of ‘arrangement’ overly broad. On the other hand, this is subject to the ‘outright gift’ exception which is also overly broad, as indicated by the result in *Jones v Garnett*.<sup>932</sup> Not only will 50-50% husband and wife shareholdings as in *Jones v Garnett* fall into the outright gift exception, but if Mr Jones had instead owned a mere 5% of the Arctic shares with Mrs Jones owing the other 95% this arrangement likely would also be an outright gift.

One option is to extend the scope of the carve-out to the outright gift exception in ITTOIA section 626(4) so that dividends (including dividends on ordinary shares) from family companies as well as family partnership profits do not qualify as outright gifts to the extent that the dividends paid or profits allocated to each partner do not reflect the amount that would have been paid in a non-arm’s length situation. As mentioned above,

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<sup>932</sup> *Jones* (HL) (n 713).

the inability to effectively deal with the transfer pricing issue in the case of jointly-produced business income, as exemplified by *Jones v Garnett*, is the most glaring weakness in the present state of the law. HMRC is unable to effectively challenge situations where one spouse appears to be receiving a greater share of the business profits than might be warranted by his or her relative contribution to the business. This situation allows taxpayers to self-select out of the individual tax unit and the control model of income attribution, undermining both and reducing the tax take in the process.

Requiring the distribution of profits to adhere to the arm's length principle using a method such as profit split to arrive at an appropriate attribution of income to the family members (as discussed at length in Chapter 4<sup>933</sup>) is one way to address this deficit. Some consideration could be given to narrow the potential scope of application to situations in which the settlor is 'active' in the business (as in the Swedish approach) and/or to a limited range of entities such as partnerships and 'close companies', defined in ICTA 1988 section 414 (and not rewritten in CTA 2009) as, very generally, a company controlled by five or fewer persons. As Crawford and Freedman point out, however, relying on a defined sub-category of company such as 'close companies' tend to result in highly complex definitions that are difficult to apply.<sup>934</sup> It is similarly difficult to separate out passive investors from active shareholders.<sup>935</sup>

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<sup>933</sup> See text beginning at n 579.

<sup>934</sup> Crawford and Freedman (n 94) [II.2] and Appendix I.

<sup>935</sup> Crawford and Freedman (n 94) [II.2].

As an alternative to an arm's length, transfer pricing approach, the UK could incorporate a simpler 'reasonableness' test into ITTOIA section 626(4) along the lines of the Canadian rules applicable to partnerships and the US rules discussed in Chapter 4.<sup>936</sup> As noted in that Chapter, this alternative suffers from similar concerns as the arm's length principle method over the certainty of its application, but is less formalistic than a transfer pricing approach and could impose a lower compliance burden. Smiley and Motter argue that such a reasonableness test would work in the UK in situations like that in *Jones v Garnett*.<sup>937</sup>

'...[T]he "reasonable compensation" standard has been applied in the US for over 50 years and, while it has engendered a vast number of litigated cases, the principles are now well understood and the logic hard to challenge. We believe that something similar, if carefully crafted, could be a workable method to address income shifting in the UK.'

Under this approach, the ITTOIA section 626(4) carve-out could be amended so that dividends from family companies as well as allocations of family partnership profits do not qualify as outright gifts to the extent that the dividends and profits are not reasonable in the circumstances given the nature and extent of work performed for the business, capital contributed and risk assumed by the recipient. This language provides guidance to taxpayers and the courts as to the purpose of the provision and the factors to be taken into account. It has the advantage of being flexible enough to apply in a variety of business situations (like the arm's length test). HMRC could also apply detailed guidance with realistic examples to enhance certainty. Notwithstanding the 'vast' US case law on its

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<sup>936</sup> See text beginning at n 607.

<sup>937</sup> Smiley and Motter (n 198) 40.

test, as with the transfer pricing approach even a few test cases would be very helpful in laying out guidance for taxpayers and HMRC. Again, if necessary, the scope of the amendment could be limited to ‘close companies’.

Finally, as previously mentioned, the settlements provisions should apply in the same way to some similarly-situated unmarried cohabitants as they do for married spouses and civil partners. Recently, other anti-avoidance rules such as the managed service company rules have targeted both married couples / civil partners as well as unmarried cohabitants living together as husband and wife / civil partners. This is an important advance given the increasing number of unmarried cohabitants, and one that should be incorporated into the settlements provisions. For the reasons discussed in Chapter 3,<sup>938</sup> where it is desirable to take into account a taxpayer’s personal relationships—eg for anti-avoidance legislation—reliance on specific forms of relationship such as marriage should be eschewed in favour of a more comprehensive and principled approach to the legal recognition and support of the full range of close personal relationships among adults. As the Law Commission of Canada recommended, this approach should be guided by the values of equality and autonomy. In the case of the settlements provisions, this objective could be implemented by adding unmarried cohabitants ‘living together as man and wife or civil partners’ to the initial scope of the rules in ITTOIA section 625 deeming spouses to have an interest in each other’s property and to the outright gift exception in section 626. The provisions would thus operate in a more neutral way as between married and unmarried couples. It would also deflect any

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<sup>938</sup> See text beginning at n 300 and, in particular, the text beginning at n 332.

criticisms that expanding the reach of the settlements provisions as proposed constitutes an attack on the institution of marriage.

### **3. CONCLUSION**

The operation of the settlements provisions would be better targeted and more effective if minor amendments were made to section 626(4) of the settlements legislation, or perhaps by inserting a new section 626(4A). Appropriate guidance from HMRC combined with a few cases allowing the courts to work out the new rules in actual fact patterns will, over time, minimise concerns over complexity and uncertainty. The major downside to this approach is that even if the settlements provisions are strengthened in this way, with an increase in complexity and uncertainty for taxpayers, this still has not addressed the tax arbitrage issue—a taxpayer like Mr Jones will still be able to convert labour income into more lightly taxed dividend income. Neutrality between business forms continues to be problematic because incentives remain for taxpayers to incorporate rather than carry on activities as employees in search of lower taxes generally as well as the income-splitting advantages. This result also violates the principle of horizontal equity. The remaining options for reform are aimed at enhancing neutrality and restricting the scope for tax arbitrage.

#### **D. EXPAND THE SCOPE OF THE EMPLOYMENT TAX REGIME**

Another option for reform, instead of or along with amending the settlements provisions, that involves pursuing greater neutrality in the taxation of labour income earned through employment with the taxation of labour income earned through unincorporated or

incorporated business form is to expand the scope of the employment tax regime. As discussed in Chapters 2<sup>939</sup> and 4,<sup>940</sup> some disagree with the premise that business activities can ever be compared to employment activities, but imposing employment tax rules on employment-like activities carried out in non-employment form reduces the incentives for taxpayers to incorporate in the first place in order to transform what would otherwise be salary or self-employed income into lower-taxed dividends that could then be sprinkled amongst family members. As discussed in Chapter 4, it is very difficult for employees to engage in successful splitting of their employment income because the UK employment tax rules tax employees on payments made and benefits provided to their family members.<sup>941</sup> If the scope of these rules were increased, some existing business income-splitting arrangements could be curtailed.

## **1. EXPAND THE BOUNDARIES OF EMPLOYMENT TAX**

The most obvious way to extend the scope of the employment tax regime is to move the current boundaries between employment and self-employment, and between employment and incorporated businesses. These possibilities are discussed next.

### **(a) The Employment—Self-Employment Boundary**

As briefly mentioned in Chapter 4, whether a UK worker is an ‘employee’ and thus subject to employment tax on his or her earnings is determined under heavily fact-based

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<sup>939</sup> Chapter 2, text at n 61.

<sup>940</sup> Chapter 4, text at n 478.

<sup>941</sup> Chapter 4, text at n 517 discussing ITEPA s 201.

common law tests aimed at distinguishing a contract ‘of’ service (employment) from a contract ‘for’ service (self-employed).<sup>942</sup> The courts will weigh a number of factors, including the intention of the parties to the engagement, the degree of control exercised over the worker and whether the worker is carrying on business on his or her own account and open to the prospect of profit and risk of loss.<sup>943</sup> One option to expand the scope of employment tax is to treat some classes of self-employed workers as employees regardless of their status under the case law.<sup>944</sup> Another option is extending employment tax provisions to cover ‘workers’, defined to cover some of those who would otherwise fall in the grey area between activities that are clearly employment and clearly self-employment.<sup>945</sup>

Although it is possible to expand the scope of the employment regime to cover workers who may otherwise fall just over the boundary into self-employment if the common law tests were applied, it is difficult to make a case for expanding the employment regime in this way solely to restrict family income-splitting arrangements. In any event, if the concern is that the self-employed can divert income by paying salaries to family members, this form of income splitting is subject to some limitations imposed by the ‘wholly and exclusively’ test for deductibility.<sup>946</sup> There are other benefits, however,

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<sup>942</sup> Chapter 4 text at n 480.

<sup>943</sup> See eg *Market Investigations Ltd v Minister of Social Security* [1969] 2 QB 173, *Ready Mixed Concrete (South East) Ltd v Minister of Pensions and National Insurance* [1968] 2 QB 497. See also Freedman (n 96) Ch 3, Crawford and Freedman (n 94) [III.2.3] and Tiley (n 23) [13.2].

<sup>944</sup> Freedman (n 96) [4.27-.77].

<sup>945</sup> Freedman (n 96) [4.107-.117].

<sup>946</sup> See text beginning at n 623.

in terms of advancing neutrality and horizontal equity at the boundary, and HMRC continues to monitor this border (especially in the construction industry).<sup>947</sup>

### (b) The Employment—Incorporated Business Boundary

A UK worker who is employed through an intermediary (such as a ‘one-man’ company owned by the worker) may be subject to employment tax on payments received by the intermediary for the worker’s services where the relationship between the worker and the intermediary’s clients satisfies the common law tests for a contract of service. However, these ‘personal services company’ rules in ITEPA Part 2 Chapter 8, known generally as the ‘IR35’ rules after the government press release announcing their introduction, have not proven to be especially effective.<sup>948</sup> One reason is because the IR35 regime relies on the common-law test for employment, which as just discussed is very much fact-dependent. In addition, taxpayers were able to circumvent the rules by using third-party service companies.<sup>949</sup> In 2007, the Government attempted to address these and other shortcomings in the IR35 regime, not by amending the rules but instead by laying an entirely new regime on top of the existing IR35 rules called the managed service companies (MSCs) regime. The new rules in ITEPA Part 2 Chapter 9 target MSC

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<sup>947</sup> HMRC’s latest approach is the Construction Industry Scheme: see <<http://www.hmrc.gov.uk/cis>> accessed 2 October 2009.

<sup>948</sup> Crawford and Freedman (n 94) [III.3.2] and Tiley (n 23) [13.2.3.2].

<sup>949</sup> Tiley (n 23) [13.2.3.2].

‘providers’ and provide rules for imposing a deemed employment income amount and excluding distributions by the MSC from taxation as dividends.<sup>950</sup>

Expanding the scope of intermediary-regimes like the IR35 and MSC rules is one way to achieve greater neutrality and horizontal equity at the employment-incorporated business boundary. Again, however, it is not a complete approach, and the gains to be had are limited. In particular, if the impugned activity is in reality a joint activity that relies on the contributions (even if unequal) of more than one family member (as in *Jones v Garnett*), it is inappropriate to attempt to tax such activity as if it was employment carried on by one family member.

## 2. TAX DIVIDENDS FROM FAMILY COMPANIES AS REMUNERATION

As discussed in the previous Chapter, some commentators believe that the employment-related securities provisions in ITEPA section 447 may provide the authority for taxing dividends paid by family companies as employment income in some situations.<sup>951</sup> If this is indeed possible, it does not appear that HMRC has yet done so.<sup>952</sup> Even if section 447 as presently drafted is not effective, the provision could be amended, as Hutton warned HMRC may be contemplating,<sup>953</sup> to clearly recharacterise dividends like those paid to Mr and Mrs Jones as employment income.

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<sup>950</sup> See Crawford and Freedman (n 94) [III.3.2] and Tiley (n 23) [13.2.3.2].

<sup>951</sup> Text beginning at n 867.

<sup>952</sup> As of August 2009 the Professional Contractors Group is not aware of any of their members being so targeted, but it promises to resist any such attacks if and when they occur: see PCG (n 870) 1.

<sup>953</sup> Text at n 876.

Alternatively, new legislation could be introduced to specifically tax dividends from small family companies as remuneration. This option could advance neutrality and horizontal equity between employment activities and functionally-similar activities carried on through a company. Chittenden and Sloan, for example, argue that the UK tax system should be altered to achieve equity between the categories of employment, self-employment and operating as an incorporated firm because this would deter tax-motivated incorporations and would be preferable to the resource-intensive status tests currently used when attempting to reclassify workers as employees.<sup>954</sup> Using data from the Office of National Statistics, Chittenden and Sloan estimate that between 26.9 and 67.1 per cent of the nearly four million UK incorporated businesses employing four people or less may be employees operating tax-motivated contract for services arrangements.<sup>955</sup>

The authors suggest one way of achieving equity with employees is for dividend income of all ‘close companies’ to be reclassified as remuneration subject to NICs.<sup>956</sup> They also note that such a measure would discourage the removal of business profits.<sup>957</sup> However, the authors do not discuss how their proposal would work in detail. Further, they suggest differences in the rates of NICs between the self-employed and employees

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<sup>954</sup> Francis Chittenden and Brian Sloan, ‘Quantifying Inequity in the Taxation of Individuals and Small Firms’ [2007] BTR 58, 62.

<sup>955</sup> Chittenden and Sloan (n 954) 62.

<sup>956</sup> Chittenden and Sloan (n 954) 62.

<sup>957</sup> Chittenden and Sloan (n 954) 62.

might also be addressed, perhaps by merging income tax and NICs (as discussed in a later section in this Chapter).<sup>958</sup>

### **3. CONCLUSION**

In conclusion, expanding the scope of employment taxation by moving the borderline between employees/self-employed and employees/companies or taxing dividends from small family companies as remuneration may go some ways towards restricting family income-splitting arrangements. Re-thinking the borderlines addresses those situations around the borders where horizontal equity concerns are most acute, as well as advancing neutrality and reducing compliance and administrative burdens. The gains to be had from such an approach, however, are limited. At best it will catch only the most egregious income splitting where one family member is practically solely responsible for generating the income of the business such that a fair comparison can be drawn with an employee performing similar activities.

A better approach is to address the systemic differences in the tax and NIC treatment of employees, unincorporated and incorporated businesses that provide an incentive to employees to attempt to disguise or convert their employment income into business income in the first place. This approach is discussed next.

## **E. ALIGN TAX TREATMENT OF INCORPORATED AND UNINCORPORATED BUSINESSES**

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<sup>958</sup> Chittenden and Sloan (n 954) 62-63.

Another simple and fairly easy to implement option to address the kind of income splitting at issue in *Jones v Garnett* is to limit taxpayers' incentive to incorporate in the first place by reducing the differences in tax and national insurance treatment of different business forms discussed in Chapter 4.<sup>959</sup> It will be recalled that Crawford and Freedman found for income/profits of £75,000 per annum the total tax (income and corporations tax) and NIC as a percentage of gross income/profits using 2008-09 rates was 37.7% for the employed, 31.8% for the self-employed and 24.5% if earned through a company.<sup>960</sup> Closer alignment of this tax and NIC treatment is considered further next.

## **1. ALIGN TAX TREATMENT**

The discussion in Chapter 4 on neutral tax treatment of functionally-similar activities irrespective of legal form determined that from a policy perspective it may well be appropriate in some cases to characterise business income (ie self-employment earnings, partnership profits, and even company profits) arising from employment-like activities as labour income, as Gammie, Crawford and Freedman, the Meade Committee and the Carter Committees conclude. The tax treatment and income attribution model that applies for employment, it was argued, is just as appropriate on neutrality and horizontal equity grounds for these business profits, especially in the case of a one-person personal services business (incorporated or unincorporated) requiring little if any capital.

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<sup>959</sup> See text beginning at n 478.

<sup>960</sup> Crawford and Freedman (n 94) Appendix III, Table III.1 using tax rates in effect for 2009-10.

In the 2007 Budget Report, the Government took some steps towards aligning the tax treatment of unincorporated and incorporated firms. The Government discussed its previous attempts to encourage greater investment through low rates of tax for small companies with the small companies' rate, and concluded that (perhaps unsurprisingly) this had led some people to incorporate their business with the main aim of reducing their personal tax and NIC liability by extracting labour income as dividends.<sup>961</sup> The Government correctly noted that this resulted in an unfair difference between the overall tax and NICs paid by the incorporated and the unincorporated, and, if left unaddressed, such tax-motivated incorporation posed a growing risk to the Exchequer.<sup>962</sup> As a result, the small companies rate was to rise to 22% and the basic rate of personal income tax fall to 20%. What the Government neglected to say was that the Chancellor encouraged such incorporations in the first place by introducing a 0% starting rate of tax in 2001.<sup>963</sup>

Since the 2007 announcements, however, the alignment process has gone into reverse. Budget 2009 froze the small companies' rate at 21%,<sup>964</sup> and increased NICs by 0.5%.<sup>965</sup> Moreover, from April 2010, the top marginal personal income tax rate is set to rise from 40% to 50% on income over £150,000 and those taxpayers with income between £100,000 and approximately £113,000 will face a 60% marginal tax rate on that income from the withdrawal of personal allowances.<sup>966</sup> These changes are an unfortunate

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<sup>961</sup> HM Treasury, 'Budget 2007' (n 652) [3.22].

<sup>962</sup> HM Treasury, 'Budget 2007' (n 652) [3.22].

<sup>963</sup> This 0% starting rate saga is described in Freedman (n 650) 16-20.

<sup>964</sup> HM Treasury, '2009 Budget' (n 7) [4.10].

<sup>965</sup> HM Treasury, '2009 Budget' (n 7) [5.88].

<sup>966</sup> HM Treasury, '2009 Budget' (n 7) [5.88].

development from the standpoint of neutrality of tax treatment of business form. As the Government said in 2007, the combination of a higher small companies' rate and lower personal tax rates goes some way towards aligning the tax treatment of incorporated and unincorporated businesses, thereby reducing the tax incentives to incorporate. Fewer incorporated businesses in turn will mean fewer opportunities to income-split by dividend-sprinkling. The recent increases in personal rates and a halt to planned increases in the small companies rates, however, has the opposite effect.

Tax rates are only one part of the alignment story. The following sections discuss other ways to enhance the alignment of the tax and also NIC treatment of business forms, focusing first on NICs.

## **2. ALIGN NATIONAL INSURANCE CONTRIBUTION TREATMENT**

Aligning the tax treatment of labour income earned through employment with labour income earned through unincorporated/incorporated firms will not completely eliminate the fiscal incentives to incorporate. Even if no income tax benefits could be gained by incorporating, the more favourable NIC treatment of corporate profits (distributed and undistributed) as compared to income earned by employees and the self-employed continues to provide an incentive for family businesses to adopt the corporate structure and use it as a vehicle for income splitting. As mentioned in Chapter 2, employment earnings are subject to employee national insurance contributions (NICs) of up to 11% (capped at 1% for incomes over £40,400) as well as employer NICs of up to 12.8% (for

2008-09).<sup>967</sup> The self-employed, on the other hand, pay a small weekly Class 2 NIC of £2.30 as well as Class 4 NICs of 8% of their annual profits between the lower profits limit (LPL) of £5,435 and upper profits limit (UPL) of £40,040, plus a further 1% on profits above the UPL (for 2008-09).<sup>968</sup>

Lower contribution rates for the self-employed can be justified to some extent by their reduced benefit entitlement, eg they are not entitled to contribution-based jobseeker's allowance. However, even after accounting for this reduced benefit entitlement, the Government estimates that for 2008-09 the Treasury will take in £1.95 billion less in NICs from the self-employed than it would have done had the Class 1 primary and secondary contribution system applied.<sup>969</sup> Removing the differences in tax and NIC treatment between employees and the self-employed advances neutrality and equity, and, as Freedman argues, could go some way to reducing the employee/self-employed classification, which has long been a difficult area under both tax and national insurance.<sup>970</sup>

On top of the preferential treatment provided for self-employed persons compared to employees, the NIC regime provides even more favourable treatment of the profits of incorporated versus unincorporated businesses. First, no NICs are levied on the profits of companies whilst self-employed persons, as just mentioned, are subject to an 8% charge

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<sup>967</sup> Text at n 90.

<sup>968</sup> HM Revenue & Customs, 'Rates and Allowances - National Insurance Contributions' (n 89).

<sup>969</sup> HM Treasury, '2008 Pre-Budget Report: Tax Ready Reckoner and Tax Reliefs' Table 7 (November 2008) <[http://www.hm-treasury.gov.uk/d/pbr08\\_taxreadyreckoner\\_287.pdf](http://www.hm-treasury.gov.uk/d/pbr08_taxreadyreckoner_287.pdf)> accessed 16 June 2009, 18.

<sup>970</sup> Freedman (n 96) [1.16].

on their annual profits between £5,435 and £40,040, plus a further 1% on profits above £40,040. This difference in treatment alone provides a significant fiscal incentive for the self-employed to incorporate. Furthermore, NICs are not levied on distributed profits either. Since no NICs are charged on dividends, taxpayers like Mr Jones are encouraged for fiscal reasons alone to incorporate their simple business and pay dividends instead of additional, NIC-able salary over and above the approximately £5,000 per year level that does not attract employee and employer NICs. Usually the amount of dividends paid is the amount that can be paid to the lower-rate paying spouse without attracting the 25% additional tax that a higher-rate paying taxpayer would be liable to pay. Moreover, since dividends are not deductible the ‘wholly and exclusively’ test does not act as a limit on the amount of dividends that can be paid.

What reforms could be made to the NIC regime to reduce or eliminate the incentives for employees to pursue self-employed treatment, and, more importantly for present purposes, for the self-employed to incorporate? A relatively simple option (though politically difficult) would be to align the rate of NICs paid by employees with the self-employed; however, this would not reduce the employment-incorporation NIC differential.<sup>971</sup> Two other possible options are discussed below.

#### (a) Integrate Income Tax and National Insurance Contributions

A radical but comprehensive option for eliminating the NIC incentives to incorporate and then to enter into income-splitting arrangements is to integrate the tax and NIC regimes.

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<sup>971</sup> See Crawford and Freedman (n 94) [IV.3.1.].

Calls for integration have been made on several fronts,<sup>972</sup> and the calls have grown in recent years as the Labour Government continues to increase NICs rather than income tax as a way of raising revenue<sup>973</sup> without (until the 2008 Pre-Budget Report) violating the Labour Party's 2001 campaign promise not to raise income tax.<sup>974</sup> Recently, the Forsyth Commission established by the Conservative Party proposed aligning the basis of charge and the period of charge for NICs and income tax and suggested NICs be charged on aggregate income from all employments like income tax.<sup>975</sup> The Commission further proposed considering merging NICs and income tax in a phased manner.<sup>976</sup> Similarly, in its comments on the Government's 2007 income-shifting proposals the CIOT stated:<sup>977</sup>

'...integration of income tax and National Insurance would bring far more to the table than reducing employers' administrative burdens. It would give rise to a significant saving in burdens for individuals. In addition, it would reduce the incentive for [owner-managed businesses or] OMBs to incorporate and their owners to extract funds by way of dividends. We think the subject of integration should be revisited in the context of a thoroughgoing review of the taxation of OMBs.'

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<sup>972</sup> See eg Andrew Dilnot, J A Kay and C N Morris, *The Reform of Social Security* (OUP, Oxford 1984); Andrew Dilnot, 'Integrating Tax and Social Security' in C Sandford (ed) *More Key Issues in Tax Reform* (Redwood Books, Trowbridge 1995); Adam and Loutzenhiser (n 90).

<sup>973</sup> For example, in the 2002 Budget the Government introduced a 1% increase in NICs for employees, employers and the self-employed: see HM Treasury, 'Budget 2002' (HC 592, 2002) [1.14]. Most recently, the Government announced in the 2008 Pre-Budget Report that NIC rates will increase by 0.5% from April 2011: see HM Treasury, 'Pre-Budget Report November 2008' (n 5) [5.8].

<sup>974</sup> See, eg, Editorial, 'Labour Launches "Ambitious" Manifest' *Guardian* (London 16 May 2001) <<http://www.guardian.co.uk/politics/2001/may/16/election2001.uk4>> accessed 22 July 2009 ('The prime minister, Tony Blair, today launched Labour's election manifesto, promising no increase in income tax and thousands more teachers, doctors, nurses and police.'). Following this 2001 campaign promise not to raise income tax, the 2002 Budget raised NICs by 1%.

<sup>975</sup> Conservative Party Tax Reform Commission (n 400) 66-8.

<sup>976</sup> Conservative Party Tax Reform Commission (n 400) 68-9.

<sup>977</sup> Chartered Institute of Taxation (n 148) [4.7].

Full integration of income tax and NICs has several advantages.<sup>978</sup> The first advantage is transparency. Although income tax and NICs are very similar taxes, they are not identical, and their combined effect is a function of their combined rates and their different bases; the result is obscure.<sup>979</sup> Integrating income tax and NICs would make the overall rate structure of labour taxation more obvious. Furthermore, issues such as the balance of taxation between labour and capital income, the self-employed and employees, the young and pensioners and so on would be more explicit and easier to debate.<sup>980</sup>

Secondly, the existence of the two separate systems entails substantial costs: compliance costs for employers, employees and the self-employed, and administration costs for government.<sup>981</sup> For example, whilst employers withhold from employees' pay both income tax and NICs, the income tax amount is computed on a cumulative basis over the tax year, whilst NICs are computed on a non-cumulative, pay period basis.<sup>982</sup> KPMG's study for HMRC on the tax compliance burden on businesses noted that 'a significant number of businesses considered that NICs and income tax should be rolled into one, so that there were not two different taxes covering the same payments'.<sup>983</sup> Integrating the income tax and NIC systems has the potential to reduce the administrative and compliance burdens substantially, particularly for employers. Less radically, further steps towards alignment of the income tax and NIC base as it applies to employment

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<sup>978</sup> For a detailed discussion of integration of income tax and NICs see Adam and Loutzenhiser (n 90).

<sup>979</sup> Adam and Loutzenhiser (n 90) 14-15.

<sup>980</sup> Adam and Loutzenhiser (n 90) 14-15.

<sup>981</sup> Adam and Loutzenhiser (n 90) 14-15.

<sup>982</sup> Adam and Loutzenhiser (n 90) 14-15.

<sup>983</sup> KPMG (n 132) Part 11, [5.1].

earnings, as well as thresholds (ie personal allowance for income tax and primary threshold for NICs), could be taken. Significant progress had been made in recent years on aligning thresholds in particular,<sup>984</sup> although this progress has been reversed somewhat when the personal allowance (but not the NIC primary threshold) was increased in 2008 in response to criticism over the withdrawal of the 10% rate of income tax, as well as by the introduction of a new 50% top income tax rate combined with the withdrawal of personal allowances for very high-income earners.<sup>985</sup> A 2007 study by HM Treasury also recommended against further alignment.<sup>986</sup>

In summary, integrating income tax and NICs is an intriguing but fairly radical proposal that is likely politically unfeasible, at least in the short term. A NIC charge on pensions, dividends and interest and a higher NIC charge on self-employed earnings would be very unpopular with politically vocal groups such as pensioners and small business persons. In addition, although full integration of income tax and NICs is conceptually attractive on equity and administrative grounds—since NICs presently are levied on labour income but not capital income—and would advance tax neutrality irrespective of business form, full integration represents a move away from the

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<sup>984</sup> Most notably, the levels of weekly earnings at which employees and employers start paying NICs were aligned with the weekly level of the income tax personal allowance in 1999 (for employer contributions) and 2001 (for employee contributions). In addition, Budget 2007 announced that the NIC Upper Earnings Limit (for employees) and Upper Profits Limit (for the self-employed) were to be similarly aligned with the higher rate Income Tax threshold from April 2009: see Adam and Loutzenhiser (n 90) 8-9.

<sup>985</sup> See text above at n 7 and Browne (n 90) [11.1-.3].

<sup>986</sup> HM Treasury, 'Income Tax and National Insurance Alignment: An Evidence-Based Assessment' (2007) <[http://www.hm-treasury.gov.uk/media/B/B/pbr\\_csr07\\_incometax713.pdf](http://www.hm-treasury.gov.uk/media/B/B/pbr_csr07_incometax713.pdf)> accessed 21 October 2008.

international trend towards lower taxes on capital. This could be offset, however, by increasing income tax rates on labour and/or decreasing income tax rates on capital.

### (b) Levy National Insurance Contributions on Dividends

An alternative, and less radical, option for reducing the NIC incentives for income-splitting arrangements of the kind seen in *Jones v Garnett* is to levy NICs on at least some types of dividends, such as those from closely-held family corporations.<sup>987</sup> A NIC charge on dividends also advances neutrality and equity vis-à-vis employees and unincorporated businesses, reduces the scope for NIC avoidance, and mitigates the differences in treatment of business profits under the tax and NIC regimes. Focusing on the avoidance issue, Heaton argues that the government ‘could knock on the head all the abusive (and the effective) arrangements by the simple expedient of levying a Class 5 contribution at the rate of (say) 13.8%, so as to be equivalent to Class 1 on earnings above the upper earnings limit.’<sup>988</sup> He goes on to suggest that like Classes 1A, 1B and 4, it might attract no benefit entitlement, and it might apply to dividends from close companies paid to any working shareholder or member of his or her immediate family. This treatment is similar to the treatment of excess dividends under a Nordic-style DIT.

## 3. FLOW-THROUGH TREATMENT

Another option for aligning the tax treatment of unincorporated and incorporated businesses is to allow (or require) small companies to be taxed on a flow-through basis

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<sup>987</sup> Francesca Lagerberg, ‘Arctic Chill’ (9 August 2007) 160 Taxation 149

<sup>988</sup> David Heaton, ‘New and NICable’ (17 April 2006) 833 Tax J 9.

along the lines of a sole proprietorship or partnership. The US permits taxpayers to elect this form of tax treatment for certain types of companies known as S-Corporations.<sup>989</sup> Flow-through treatment has been proposed in Australia<sup>990</sup> and floated by the CIOT in its commentary on the Government's 2007 income-splitting draft legislation.<sup>991</sup> The flow-through approach was considered, and summarily rejected, by Crawford and Freedman in their Mirrlees paper, however, for two principal reasons.<sup>992</sup> First, flow-through treatment in the US overcomes the economic double taxation inherent in the US's classical corporation tax system; the UK, on the other hand, gives some measure of credit for tax paid at the corporate level.<sup>993</sup> As a result, 'the need for pass-through treatment in terms of reducing double taxation on corporate dividends is not readily apparent'.<sup>994</sup> Second, the use of S-Corporations has been severely criticised for allowing taxpayers to escape employment taxes including social security contributions, and for their use in other forms of tax avoidance.<sup>995</sup> For these reasons, the flow-through option is not an attractive option for the UK.

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<sup>989</sup> In order to elect S Corporation status the company must have less than 100 shareholders, only one class of shares and satisfy certain other requirements. Despite these restrictions, S Corporations account for a significant part of corporate ownership in the US: see Auerbach, Devereux and Simpson (n 94) 35.

<sup>990</sup> Judith Freedman, 'Reforming the Business Tax System: Does Size Matter? Fundamental Issues in Small Business Taxation' in Chris Evans and Rick Krever (eds) *Australian Business Tax Reform in Retrospect and Prospect* (Thomson, Sydney 2009) 126, 131-33.

<sup>991</sup> Chartered Institute of Taxation (n 149) [4.4.2].

<sup>992</sup> Crawford and Freedman (n 94) [IV.2.3].

<sup>993</sup> Crawford and Freedman (n 94) [IV.2.3].

<sup>994</sup> Freedman (n 990) 132.

<sup>995</sup> Freedman (n 990) 131; Crawford and Freedman (n 94) [IV.2.3] ('Far from increasing alignment between legal forms, it provides greater opportunities for obtaining tax advantages by using one form rather than another'.) The authors also note that businesses seeking limited liability protection combined with flow through treatment can opt to set up as limited liability partnerships

#### 4. A NORDIC-STYLE DUAL-INCOME TAX

The alignment approaches discussed in the previous sections have some similarities with the Nordic dual income tax (DIT) systems introduced in the late 1980s and early 1990s and, as discussed in Chapter 4, in their paper for the Mirrlees Review, Griffith, Hines and Sørensen examined the possibility of a DIT for Britain.<sup>996</sup>

It will be recalled that the DIT is a schedular income tax that combines a progressive tax on labour income with a low flat rate of tax on income from capital.<sup>997</sup> Capital income for this purpose includes interest, dividends, capital gains, rental income, and also imputed returns on owners-occupied housing.<sup>998</sup> Owners of unincorporated firms are also permitted to impute a return to their business equity; this return is taxed as capital income and the residual business income is taxed as labour income.<sup>999</sup> Those owners concerned about the compliance costs involved and/or those with little capital invested can opt to have their entire business income taxed as labour income.

As discussed in Chapter 4, under the Swedish variation, dividends paid to active shareholders of closely-held companies in excess of an ordinary return on capital invested are taxed as labour income.<sup>1000</sup> The post-2006 Norwegian model uses a shareholder income tax combined with a rate of return allowance (RRA). The RRA exempts all

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(LLPs). Few have taken this option, which suggests to the authors that the demand for flow-through treatment is not high.

<sup>996</sup> Griffith, Hines and Sørensen (n 83) 72.

<sup>997</sup> Griffith, Hines and Sørensen (n 83) 72-77. See also Sørensen (n 499).

<sup>998</sup> Sørensen (n 499) 8.

<sup>999</sup> Griffith, Hines and Sørensen (n 83) 73.

<sup>1000</sup> Crawford and Freedman (n 94) [IV.2.4] and Melz (n 506).

shareholder income—dividends and also capital gains—below an imputed normal rate of return on the share basis.<sup>1001</sup> Income above the normal rate of return is taxed as capital income, which when combined with the corporation tax approximates the top marginal rate of tax on labour income.<sup>1002</sup> This approach has the added advantage of taxing all shareholders in the same way, eliminating the definitional problems associated with tests like ‘active’ shareholders and ‘close companies’.<sup>1003</sup> On the other hand, the DIT still raises some difficult practical problems, including what the definition of ‘capital’ should include and how the ‘normal rate of return’ is determined. Despite these concerns, Crawford and Freedman as well as Griffith, Hines and Sørensen recommend in their respective Mirrlees papers that the UK consider adopting this approach.<sup>1004</sup>

A critical aspect of the DIT is the relationship between the tax rates on labour, capital and on company profits. Ideally, the personal tax rate on capital income is aligned with both the lowest marginal rate applicable to labour income and also the corporate income tax rate.<sup>1005</sup> The flat rate of tax on capital income is justified primarily on pragmatic grounds, namely as a means of reflecting the inflationary component of gains, reducing the ‘lock-in’ effect and, importantly for the present discussion, because it

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<sup>1001</sup> Crawford and Freedman (n 94) [IV.3.2.1] and Griffith, Hines and Sørensen (n 83) 78.

<sup>1002</sup> Excluding the effect of social security contributions (of about 6%): see Crawford and Freedman (n 94) [IV.3.2.1].

<sup>1003</sup> Crawford and Freedman (n 94) [IV.3.2.1] and Griffith, Hines and Sørensen (n 83) 80.

<sup>1004</sup> Crawford and Freedman (n 94) [IV.3.2.1] and Griffith, Hines and Sørensen (n 83) 3-4.

<sup>1005</sup> Sørensen (n 499) 8. As briefly mentioned in Chapter 4, the relationship among these tax rates is absolutely fundamental to the successful operation of the DIT. According to Griffith, Hines and Sørensen (n 83) 73, ‘if the corporate income tax rate is  $t^c$  and the top marginal tax rate on labour income is  $t^l$ , the capital income tax rate  $t^k$  should be set such that  $(1 - t^k)(1 - t^c) = 1 - t^l$  to prevent tax avoidance through income shifting’. As explained in the opening introduction to this thesis, ‘income shifting’ in this context means the conversion of labour income into capital income.

reduces the scope for and tax advantages from capital income splitting.<sup>1006</sup> So long as the right balance is struck between the tax rates on corporate profits, labour and capital, the Nordic DIT achieves level treatment between incorporated and unincorporated businesses, thus reducing the incentive to incorporate for tax reasons. If, however, the rate of tax on corporate profits was reduced without consequent changes to the tax rate on labour and capital income, owner/managers of small companies will have an incentive to be compensated with dividends out of lightly-taxed profits rather than wages and salary.<sup>1007</sup>

Whilst the DIT can advance equity and neutrality in the taxation of employees, incorporated and unincorporated businesses—which merely amending the settlements provisions will not achieve—it may not fully address the further issue of income splitting within a family business. Under the Swedish scheme, this further step is achieved for excess dividends paid from a company that are taxed as labour income by applying the labour tax rate of the higher-income spouse.<sup>1008</sup> Post-2006 in Norway, the rate structure adopted results in dividends in excess of a normal return being taxed at a rate that nearly approximates the top marginal rate of tax on labour income (when corporation tax is taken into account), thereby eliminating the economic incentives to engage in income splitting.<sup>1009</sup> Alignment of the tax rates in this way provides an attractive and elegant solution to the income-splitting issue because it does not require complex definitions or

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<sup>1006</sup> Griffith, Hines and Sørensen (n 83) 75.

<sup>1007</sup> The Norwegian and Finnish approaches to this situation were discussed in Chapter 4; see text at n 506.

<sup>1008</sup> Melz (n 506).

<sup>1009</sup> Crawford and Freedman (n 94) [IV.3.2.1] and Griffith, Hines and Sørensen (n 83) 80-81.

high compliance costs, and does not raise the privacy and autonomy concerns or the problems in defining spouses that a Swedish-like approach does.

## F. TAX AVOIDANCE APPROACHES

As the settlements provisions are anti-avoidance rules, the mischief of income splitting could be addressed by resorting to a range of other tax avoidance measures, such as a general anti-avoidance rule (GAAR) or targeted anti-avoidance rule (TAAR). These options may be worth pursuing in lieu of, or along with, a new anti-income-splitting regime or amendments to the existing settlements provisions. A thorough discussion of the advantages and disadvantages of a GAAR are beyond the scope of this thesis, but the narrower issue of the suitability of a GAAR in addressing family business income-splitting arrangements must be addressed for completeness.<sup>1010</sup> One interesting preliminary point is, as Bowler notes, the goal posts on what is considered acceptable tax planning as opposed to unacceptable tax avoidance can move over time.<sup>1011</sup> This seems to have been the case with respect to income splitting in family businesses. What was once regarded as standard tax planning between husband-wife, as evidenced by the advice provided to Mr and Mrs Jones by their accountant, is now viewed by HMRC as clear tax avoidance.

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<sup>1010</sup> The literature on tax avoidance is vast. In the UK alone since 2001 a small selection of articles would include Lord Templeman, 'Tax and the Taxpayer' (2001) 117 LQR 575; John Tiley, 'Tax Avoidance Jurisprudence as Normal Law' [2004] BTR 304; Freedman (n 102); Edwin Simpson, 'The Ramsay Principle: A Curious Incident of Judicial Reticence' [2004] BTR 358; Lord Hoffmann, 'Tax Avoidance' [2005] BTR 197; John Tiley, 'Barclays and Scottish Provident: Avoidance and Highest Courts; Less Chaos but More Uncertainty' [2005] BTR 273; Judith Freedman, 'Interpreting Tax Statutes: Tax Avoidance and the Intention of Parliament' (2007) 123 LQR 53-90.

<sup>1011</sup> Bowler (n 915) 37.

Introducing a new, over-arching GAAR for the UK is not a new idea; GAAR proposals have been made by academics<sup>1012</sup> and other groups over the years, including the Tax Law Review Committee and the Inland Revenue. In 1997 the TLRC published an extensive report on tax avoidance in which it concluded that specific anti-avoidance provisions should be the ‘first lines of defence’ against tax avoidance.<sup>1013</sup> The Committee also examined whether a more general deterrent would be useful to buttress specific anti-avoidance rules and concluded that ‘a sensibly targeted general anti-avoidance provision’ with a considered framework accompanied by appropriate safeguards for taxpayers, including a pre-transaction clearance procedure, could make a contribution to the effort to deter and counteract tax avoidance.<sup>1014</sup> The TLRC preferred a GAAR to the continued development of judicial anti-avoidance doctrines (and in particular the composite transaction doctrine or *Ramsay*<sup>1015</sup> principle) on the basis that judicial doctrines operate retrospectively without a clear framework and evolve on a case-by-case basis, which produces considerable uncertainty.<sup>1016</sup>

The Inland Revenue followed by publishing a GAAR consultative document in 1998, which included possible wording for key parts of a GAAR.<sup>1017</sup> The ensuing TLRC

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<sup>1012</sup> Freedman (n 102) arguing for a general anti-avoidance *principle* (GANTIP) rather than a rule.

<sup>1013</sup> Tax Law Review Committee, *Tax Avoidance* (The Institute for Fiscal Studies, London 1997) [4.14].

<sup>1014</sup> TLRC (n 1013) [30]. The TLRC included illustrative GAAR provisions.

<sup>1015</sup> *Ramsay (WT) Ltd v IRC* [1982] AC 300 (HL) as developed in later cases such as *Furniss v Dawson* [1984] AC 474 (HL) asserting the principle that where there is a preordained series of transactions and steps are inserted with no commercial purpose those steps are to be disregarded for fiscal purposes.

<sup>1016</sup> TLRC (n 1013) [4.7-.8].

<sup>1017</sup> Inland Revenue, ‘A General Anti-avoidance Rule for Direct Taxes’ (1998) <[http://www.hmrc.gov.uk/consult/consult\\_1.htm](http://www.hmrc.gov.uk/consult/consult_1.htm)> accessed 22 June 2009.

response was highly critical of the Inland Revenue proposals for restricting the GAAR to corporations, failing to restrict the development of parallel judicial anti-avoidance doctrines, and limiting the burden on the Revenue to justify application of the GAAR.<sup>1018</sup> The TLRC also expressed doubts over the adequacy of the proposed clearance regime given the GAAR's broad scope.<sup>1019</sup> Although the Inland Revenue proposals were not pursued further, HMRC continues to study the GAAR option and recently completed a comparative legal study of the GAARs of a number of countries<sup>1020</sup> including Canada, Australia, New Zealand, Spain, France, Ireland and South Africa in an effort 'to understand what has worked in what jurisdictions and why, and see whether there are any lessons there.'<sup>1021</sup> It is clear that HMRC remains interested in the GAAR option, but still is concerned about an accompanying pre-transaction clearances regime.<sup>1022</sup>

Freedman argues that a UK GAAR would be beneficial because it 'would provide guidance to the judiciary about the way Parliament intended tax law to be construed and authority to develop the law in a way that currently occurs only spasmodically because of

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<sup>1018</sup> Tax Law Review Committee, *A General Anti-avoidance Rule for Direct Taxes: A Response to the Inland Revenue Consultative Document* (The Institute for Fiscal Studies, London 1999) [4].

<sup>1019</sup> TLRC (n 1018) [4].

<sup>1020</sup> Some of the findings of that study are reported in David Pickup, 'In Relation to General Anti-avoidance Provisions: A Comparative Study of the Legal Frameworks Used by Different Countries to Protect Their Tax Revenues' in Judith Freedman (ed), *Beyond Boundaries: Developing Approaches to Tax Avoidance and Risk Management* (Oxford University Centre for Business Taxation, Oxford 2008) 9.

<sup>1021</sup> Dave Hartnett of HMRC, quoted in Report from the Select Committee on Economic Affairs, 'The Finance Bill 2006' HL (2005-06) 204-I [61]. See also Pickup (n 1020) 9-10.

<sup>1022</sup> Hartnett (n 1021) [64] ('...I think there is a very significant issue that arises there: how sensible would it be to offer pre-transaction clearances for what were very clearly tax avoidance arrangements? Again, how sensible is it to offer arrangements like that which then enable planners to refine their product again and again and again, as we have seen with some of our existing clearance measures, until they have got something that they think works. So there are very difficult issues to be sorted out').

rightly held concerns about legitimacy.<sup>1023</sup> Support for a GAAR, however, is not universal amongst academics. Simpson argues that calls for a legislated anti-avoidance principle are misplaced and that the judiciary could play a more effective role in policing tax avoidance by applying constitutional principles already to be found in the common law.<sup>1024</sup> Following the House of Lords decisions in *Barclays Mercantile Bank Finance*<sup>1025</sup> and *Scottish Provident Institution*<sup>1026</sup> the role of the *Ramsay* principle remains somewhat unclear, with some commentators arguing the principle is dead as a separate judicial test having been subsumed into the general purposive approach to statutory interpretation outlined in *BMBF*,<sup>1027</sup> whilst others point to the analysis and result in *SPI* as evidence that the *Ramsay* principle survives.<sup>1028</sup> The impact on UK direct taxes from the recent emergence of the ‘abuse of law’ principle in the VAT case law remains to be seen.<sup>1029</sup>

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<sup>1023</sup> Freedman (n 1010) 87; see also Freedman (n 102) 353-57.

<sup>1024</sup> Simpson (n 1010) 358-74.

<sup>1025</sup> *Barclays Mercantile Business Finance Ltd v HM Inspector of Taxes* [2004] UKHL 51.

<sup>1026</sup> *Inland Revenue v Scottish Provident Institution* [2004] UKHL 52.

<sup>1027</sup> Hoffmann (n 1010) 203 (‘The primacy of the construction of the particular taxing provision and the illegitimacy of rules of general application has been reaffirmed by the recent decision of the House in [*BMBF*]. Indeed it may be said that this case has killed off the *Ramsay* doctrine as a special theory of revenue law and subsumed it within the general theory of the interpretation of statutes, perhaps the interpretation of utterances of any kind.’). In *BMBF*, Lord Nicholls explained the modern approach to statutory interpretation as introduced into tax law by the *Ramsay* line of cases: ‘The essence of the new approach was to give the statutory provision a purposive construction in order to determine the nature of the transaction to which it was intended to apply and then to decide whether the actual transaction (which might involve considering the overall effect of a number of elements intended to operate together) answered to the statutory description’ [32].

<sup>1028</sup> Freedman (n 1010) 65-70 and Judith Freedman, ‘Converging Tracks? Recent Developments in Canadian and UK Approaches to Tax Avoidance’ (2005) 53 Can Tax J 1038, 1042 (‘The current situation does not result in stability and predictability and, in practice, gives quite considerable discretion to the courts. It is not impossible that we shall see the re-emergence of a *Ramsay* doctrine.’).

<sup>1029</sup> *Halifax plc & Others v Customs & Excise Commissioners* (Case C255/02) [2006] STC 919 (ECJ).

The TLRC concerns with judicial approaches to tax avoidance remain valid more than ten years on.

Notwithstanding Simpson's confidence in the judiciary and Freedman's call for a GAAR, the UK tax authorities in recent years have instead favoured the TAAR approach. TAARs act like 'mini-GAARs', in that although they are narrower in scope than a GAAR they are drafted using much broader language than typically is found in a specific anti-avoidance provision used to thwart particular arrangements or plug particular gaps in the legislation that taxpayers have been exploiting.<sup>1030</sup> The result has been a proliferation of rules, some relatively narrow in scope and drafted in great detail<sup>1031</sup> and others with a very broad scope and drafted in a general way,<sup>1032</sup> and substantial inconsistency in the drafting of the tests employed by these TAARs to distinguish acceptable from unacceptable taxpayer behaviour.<sup>1033</sup> Some argue these TAARs, taken together, means the UK effectively has a GAAR, but without the taxpayer protections such as clearances that the TLRC thought so necessary.<sup>1034</sup>

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<sup>1030</sup> Bowler (n 915) Appendix C lists many TAARs and highlights the variety of drafting.

<sup>1031</sup> An example of a narrow but detailed TAAR is section 83 and Schedule 26 of FA 2002 concerning derivatives.

<sup>1032</sup> An example of TAAR broadly-drafted and broad in scope is section 16A of TCGA 1992, which provides that 'allowable loss' for capital gains tax purposes does not include a loss accruing to a person if—(a) it accrues to the person directly or indirectly in consequence of, or otherwise in connection with, any arrangements, and (b) the main purpose, or one of the main purposes, of the arrangements is to secure a tax advantage.

<sup>1033</sup> The list of TAARs in Bowler (n 915) Appendix C illustrates the use of a wide-range of tests with essentially the same aim of identifying behaviour with a tax avoidance purpose, but employing a variety of terms to do so including 'benefit', 'object', 'avoidance intention', and 'purpose'. Moreover, even when the term 'purpose' is used the test is inconsistently worded as 'sole purpose', 'main purpose', 'one of the main purposes' and 'unallowable purpose'.

<sup>1034</sup> See eg Tiley (n 1010) 280.

On this point, it is important to note that the Government's 2007 income-shifting proposals included a TAAR. It will be recalled<sup>1035</sup> that in order for those provisions to apply, Individual 1 must be a party to 'relevant arrangements', or have the power to control or influence relevant arrangements. Arrangements are 'relevant arrangements' if the arrangements are not genuine commercial arrangements and it would be reasonable to draw the conclusion, from all the circumstances of the case, that the purpose, or one of the main purposes, of the arrangements is the avoidance or reduction of charge to income tax.

Notwithstanding the recent preference for TAARs, would a GAAR be a useful tool for the UK authorities in countering income-splitting arrangements involving family businesses like that at issue in *Jones v Garnett*? Tiley queried which Revenue losses before the House of Lords would have been decided differently under a GAAR; *Jones v Garnett* is on his list, but he does not arrive at a conclusion either way.<sup>1036</sup> This question is considered next, beginning with an examination of the international experience in applying GAARs in this context.

The current version of the Australian GAAR essentially requires a scheme entered into for the sole or dominant purpose (determined objectively by reference to eight listed factors) of obtaining a tax benefit.<sup>1037</sup> Where the GAAR applies, the tax authorities have

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<sup>1035</sup> See discussion above at n 903.

<sup>1036</sup> John Tiley, 'The Avoidance Problem: Some UK Reflections' in Judith Freedman (ed), *Beyond Boundaries: Developing Approaches to Tax Avoidance and Risk Management* (Oxford University Centre for Business Taxation, Oxford 2008) 67, 69.

<sup>1037</sup> Part IVA of the Income Tax Assessment Act 1936.

the discretion to make a determination cancelling the tax benefit otherwise derived.<sup>1038</sup> Pickup concludes that the Australian GAAR has proved to be a significant weapon in combating tax avoidance.<sup>1039</sup> In the particular case of family income-splitting arrangements, Australia formerly had a statutory safe harbour permitting the transfer of income without transferring the underlying property so long as the period involved was less than 7 years.<sup>1040</sup> In 2000, Australia introduced legislation limiting the ability of taxpayers to split personal services income earned through a corporation, trust or partnership with family members.<sup>1041</sup>

If a taxpayer is engaged in business income-splitting arrangements with family members and these personal services income rules do not apply, the Australian Tax Office (ATO) has taken the position that the GAAR may apply.<sup>1042</sup> The ATO suggests the GAAR would apply, for example, where a salary is paid to a taxpayer as the principal

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<sup>1038</sup> Section 177F of the Income Tax Assessment Act 1936.

<sup>1039</sup> Pickup (n 1020) 17. Evans similarly concludes that the Commissioners' faith in the GAAR as a principal weapon against tax avoidance 'has been vindicated' and the government appears generally satisfied with its current operation: see Chris Evans, 'The Battle Continues: Recent Australian Experience with Statutory Avoidance and Disclosure Rules' in Judith Freedman (ed), *Beyond Boundaries: Developing Approaches to Tax Avoidance and Risk Management* (Oxford University Centre for Business Taxation, Oxford 2008) 39 ('Part IVA is seen as effective and plans to strengthen it have been left on the shelf'). Despite the Government's satisfaction, Evans is concerned that the abundant jurisprudence on Part IVA has not led to greater certainty as to when and why the GAAR may apply.

<sup>1040</sup> Freedman (n 650) 25-28, comparing *Jones v Garnett* with the Australian Taxation Office approach to income splitting in the family business, including the application of the GAAR. Freedman preferred the term general anti-avoidance principle (GANTIP) over GAAR.

<sup>1041</sup> New Business Tax System (Alienation of Personal Services Income) Act 2000. See also guidance in Australian Taxation Office, 'Alienation of Personal Services Income: Contractors and Consultants' (July 2005) <<http://www.ato.gov.au/businesses/content.asp?doc=/content/15900.htm>> accessed 20 July 2009.

<sup>1042</sup> Australian Taxation Office, 'Taxfacts – General Anti-avoidance Rules and How They May Apply to a Personal Services Business' (March 2003) <<http://www.ato.gov.au/businesses/content.asp?doc=/content/37495.htm>> accessed 20 July 2009.

worker by his or her company and that salary is not commensurate with the value of his or her services (ie too low), and the remaining income is distributed to other family members—a *Jones v Garnett* situation.<sup>1043</sup> In the case of husband and wife personal services partnerships, however, the ATO has backed down somewhat and now takes the position that ‘genuine’ partnerships where the spouses share equally in profits and losses, even if only one spouse performs the main bulk of the work, will not be subject to challenge under the GAAR absent unusual features.<sup>1044</sup> Evans argues that this position ‘owes more to a pragmatic acceptance that there are simply too many such partnerships to challenge rather than the application of a principled approach to the issue’.<sup>1045</sup> Consequently, whilst income splitting between spouses in partnership situations may be viable in Australia, family income splitting through a company remains susceptible to challenge under the GAAR.

Canada also has a GAAR.<sup>1046</sup> Very generally, the Canadian GAAR applies to a tax avoidance transaction, which is a transaction that resulted in a tax benefit and was

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<sup>1043</sup> Australian Taxation Office, ‘Taxfacts – General Anti-avoidance Rules and How They May Apply to a Personal Services Business’ (n 1042).

<sup>1044</sup> Australian Tax Office, ‘Refocus of Income-splitting Test-case Programme’ (13 December 2005) <<http://www.ato.gov.au/corporate/content.asp?doc=/content/67313.htm>> accessed 20 July 2009 and Australian Tax Office, ‘Part IVA: The General Anti-avoidance Rule for Income Tax’ (December 2005) <[http://www.ato.gov.au/content/downloads/n14331-12-2005\\_web.pdf](http://www.ato.gov.au/content/downloads/n14331-12-2005_web.pdf)> accessed 20 July 2009, 4. See also Evans (n 1039) 40-41. The ATO’s refocus came after an unsuccessful attempt to apply the GAAR to an income-splitting situation involving large superannuation contributions made by a husband and wife personal services company. In *Ryan v FCT* [2004] ATC 2181, the taxpayer provided his computer consulting services through a company controlled by the taxpayer and his wife. The company made excessively large contributions to the wife’s superannuation relative to the value of her secretarial services for the company (for which she was paid a small salary). Applying the GAAR, the Commissioner included the excess contributions in the husband’s assessable income, but the Administrative Appeals Tribunal rejected this approach and held in favour of the taxpayer.

<sup>1045</sup> Evans (n 1039) 41.

<sup>1046</sup> CITA s 245.

primarily tax motivated,<sup>1047</sup> unless the transaction does not result in a misuse of specific provisions of the Canadian Income Tax Act (CITA) or an abuse of the provisions of the CITA read as a whole.<sup>1048</sup> Where a transaction is an avoidance transaction, the tax authorities can determine the tax consequences as is reasonable in the circumstances in order to deny the tax benefit that would otherwise have arisen.<sup>1049</sup> The Canadian tax authorities have had mixed success before the courts in GAAR cases.<sup>1050</sup> The taxpayer succeeded in the Supreme Court of Canada in *Canada Trustco Mortgage Co v Canada*,<sup>1051</sup> which was similar to the transaction at issue in *BMBF*,<sup>1052</sup> but the tax authorities prevailed in its companion case *Mathew v Canada*<sup>1053</sup> and most recently in *Lipson v Canada*.<sup>1054</sup>

The Supreme Court has held that the application of the GAAR involves three steps. First, is there a tax benefit arising from a transaction or series of transactions within the meaning of sections 245(1) and (2) of the CITA? Second, is the transaction an avoidance transaction under section 245(3), in the sense of not being arranged primarily for bona fide purposes other than to obtain the tax benefit? Third, and most importantly, was there abusive tax avoidance under section 254(4), in the sense that it cannot be

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<sup>1047</sup> CITA s 245(3).

<sup>1048</sup> CITA s 245(4).

<sup>1049</sup> CITA s 245(2).

<sup>1050</sup> Brian Arnold, 'The Canadian Experience with a General Anti-avoidance Rule' in Judith Freedman (ed), *Beyond Boundaries: Developing Approaches to Tax Avoidance and Risk Management* (Oxford University Centre for Business Taxation, Oxford 2008) 29.

<sup>1051</sup> 2005 SCC 54.

<sup>1052</sup> Freedman (n 1028) and Malcolm Gammie, 'Barclays and Canada Trustco: Further Comment from a UK Perspective' (2005) 53 Can Tax J 1047.

<sup>1053</sup> 2005 SCC 55.

<sup>1054</sup> *Lipson v Canada* (n 546).

reasonably concluded that a tax benefit would be consistent with the object, spirit or purpose of the provisions relied upon by the taxpayer?<sup>1055</sup> This third arm of the test in turn requires a two-stage enquiry: first, the court must determine the purpose of the statutory provisions conferring the tax benefit, and, second, the court must decide whether the transaction abuses or frustrates that purpose.<sup>1056</sup>

In the context of family income splitting, although Canada has specific attribution rules aimed at removing the tax benefits from intra-family transfers of assets, and has special ‘reasonableness’ rules applying to the allocation of partnership income amongst family members (as discussed in Chapter 4), the Canadian tax authorities famously lost two Supreme Court cases<sup>1057</sup> in which they attempted to challenge income-splitting arrangements similar to that undertaken in *Jones v Garnett* under general settlements-type legislative provisions.<sup>1058</sup> Moreover, unlike the situation in Australia, the Canadian revenue authorities have publicly stated that the Canadian GAAR will not be applied to family income-splitting arrangements, and particularly dividend-sprinkling arrangements.<sup>1059</sup> Some Canadian tax commentators have concluded that it would be difficult to apply the GAAR to such situations given the Supreme Court’s clear statement in one of the cases, *Neuman v MNR*, that there is no general scheme in the CITA to

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<sup>1055</sup> *Canada Trustco* (n 1051) [17], *Mathew* (n 1053) [31] and *Lipson* (n 1054) [21-23].

<sup>1056</sup> *Canada Trustco* (n 1051) [44], *Mathew* (n 1053) [32] and *Lipson* (n 1054) [25]. See also Arnold (n 1050) 29-30.

<sup>1057</sup> *McClurg v Canada* [1990] 3 SCR 1020 and *Neuman v Minister of National Revenue* [1998] 1 SCR 770. See also Duff (n 538) 364.

<sup>1058</sup> CITA s 56(2).

<sup>1059</sup> Canada Revenue Agency, *Income Tax Technical News No 16* (March 1999).

prevent income splitting.<sup>1060</sup> For this reason, it is unlikely that *Jones v Garnett*-like arrangements would be found to constitute a misuse of the provisions of the CITA or an abuse having regard to the CITA read as a whole. Others disagree, arguing that the attribution rules provide clear evidence that at least some forms of income splitting are not to be permitted.<sup>1061</sup> Since no new legislation was introduced to respond to spousal income splitting through family companies following the taxpayers' victories in the courts, dividend sprinkling remains a viable technique in Canada.

In summary, in order for a UK GAAR to operate effectively in this area there must be a clear policy against family income-splitting arrangements. Can such a policy be discerned in the current UK tax system? As discussed in detail in Chapter 4, the employment tax regime restricts the ability of employees to split their earnings with family members. The 'wholly and exclusively' test also places some restrictions on the splitting of business income amongst family members. The settlements provisions limit the ability of family members to engage in some forms of income splitting, but outright gifts between the spouses of income-producing assets are permitted so long as they are unconditional and not wholly or substantially a right to income. Taken together, these rules suggest an underlying principle of UK tax law that family income splitting is acceptable within limits, but those limits are not particularly well defined.

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<sup>1060</sup> SW Bowman, Karen Sharlow and Douglas J Powrie, 'Corporate Income Splitting Revisited: The Supreme Court Speaks' (1998) 46 Can Tax J 645, 650.

<sup>1061</sup> Duff (n 538) 364.

As the TLRC and Duff contend, a GAAR is a measure of last resort and should not be generally relied upon to address reasonably foreseeable methods of tax avoidance occasioned by statutory differences in the tax treatment of similar transactions or relationships that could be better addressed with specific legislation, such as the settlements provisions (appropriately modified).<sup>1062</sup> Freedman similarly argues that the best response is to fix the legislation not to overlay GAARs on bad legislation; greater neutrality in the taxation of employees and businesses also eliminates avoidance activity around these boundaries.<sup>1063</sup> Whatever general merits there may be in having a GAAR, the case for adopting a GAAR in the UK to police family income-splitting arrangements is not especially strong. Moreover, given the recent proliferation of TAARs generally and the TAAR included in the 2007 income-shifting proposals, if an anti-avoidance tool was adopted to attempt to limit family business income splitting, it is much more likely the UK tax authorities would choose a TAAR over a GAAR.

## G. CONCLUSION

The options for reforming the UK tax system to better address the issue of income splitting in family businesses range from doing nothing (which is far from ideal on tax

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<sup>1062</sup> TLRC (n 1013); David G Duff, 'Relationships, Boundaries and Corporate Taxation: Compliance and Avoidance in an Era of Globalization' in Judith Freedman (ed), *Beyond Boundaries: Developing Approaches to Tax Avoidance and Risk Management* (Oxford University Centre for Business Taxation, Oxford 2008) 203 and Tim Edgar, 'Designing and Implementing a Target-Effective General Anti-Avoidance Rule' in DG Duff and H Erlichman, *Tax Avoidance in Canada after Canada Trustco and Mathew* (Irwin Law, Toronto 2007) 221.

<sup>1063</sup> Freedman (n 102) 7-8 and Freedman (n 1010) 73. See also Bowler (n 915) 15-16 and Shaw, Slemrod and Whiting (n 49) 1 ('If a tax system can avoid creating unnecessary and difficult-to-police boundaries it is likely to be more robust against avoidance than one that does involve such boundaries.').

policy grounds) to radical reforms such as integrating the income tax and NICs or introducing a Nordic-style dual income tax. An anti-avoidance approach such as a GAAR or, more likely, a TAAR could be effective but relying on anti-avoidance techniques to address deficiencies in the current legislation is less ideal than fixing those deficiencies directly.

Legislation to specifically address the mischief at issue, either by amending the settlements provisions or introducing new legislation, has merit as a short-term solution at least. Of these two approaches, amending the settlements provisions to enable these rules to apply in husband and wife situations like in *Jones v Garnett* when one of the spouses is receiving compensation that is unreasonable or not consistent with the arm's length principle given the spouses' relative contributions is simpler to implement and more certain than introducing an entirely new legislative regime. This would not, however, address the non-neutral treatment of employment income versus business income generated from similar activities. Other reforms that expand the scope of employment tax (by taxing dividends from family companies as employment income) should also be pursued. Over the long term, a more radical but theoretically strong approach to enhancing the equity and neutrality of the taxation of employment and business income is to pursue the Nordic-style dual income tax option.

## CHAPTER SEVEN: CONCLUSION

As the UK Government has discovered, income-splitting arrangements involving family businesses raise difficult issues for a progressive income tax system. Optimal tax theory sheds some light on these issues, but the traditional criteria of good tax design—equity, neutrality, certainty and administrative ease—move quickly to the forefront. Generally it is equity considerations, and more particularly horizontal equity, that are most central to the income-splitting debate. Should married couples be treated more (or less) favourably than unmarried cohabitants with respect to tax generally and income splitting in particular? Are employees treated unfairly compared to business persons engaged in similar economic activity because it is more difficult to split employment earnings with family members? Is it fair to allow couples with income-producing assets or family businesses to split income, but not couples with only employment income? Should some types of family business income-splitting arrangements be permitted, but not others? These are the central questions this thesis considered.

In order to answer these and other questions, the preliminary issue of choice of tax unit needed to be addressed. One cannot sensibly discuss why some view income-splitting with family members as problematic, nor the possible reforms to reduce the tax incentives to engage in it, until policy makers have decided on the appropriate unit for taxation and on rules for attributing income to the chosen units. Adopting a joint spousal tax unit rather than an individual tax unit would have the effect of reducing potential tax gains from shifting income. The arguments examined in Chapter 3, however, strongly favour an individual tax unit over a joint spousal unit. Although couples neutrality and

reducing the incentive to income split favour a joint unit, the individual is the better choice on privacy, autonomy, equality, definitional, marriage neutrality and work incentive grounds. The definitional issues inherent in a non-individual unit (ie who is a 'spouse') are particularly difficult from a horizontal equity, certainty, and ease of administration perspective given the rise in the number of unmarried cohabitants. Neutrality amongst choice of form of personal relationships, and avoiding the secondary-earner bias are also important arguments in favour of the individual tax unit.

Once the individual is chosen as the income tax unit, income attribution rules are necessary, and need to be respected, in order to prevent couples from self-selecting out of individual taxation and undermining that choice. In deciding how income should be attributed, a difficult question arises as to whether different attribution rules and tax rules generally should apply to unearned income (eg interest, dividends and capital gains and referred to as 'capital income' by economists) as compared to earned income (referred to as 'labour income' by economists). Tax policy commentators may disagree on exactly how unearned/capital income should be taxed (eg not at all, at a low flat rate, at marginal rates bearing some relation to the marginal rates applicable to labour income, at the same rate as labour income), but the resulting conclusion is that it is appropriate to tax unearned/capital income differently than labour income. In addition, it appears appropriate in some cases to characterise business income (ie self-employment earnings, partnership profits, and even company profits) arising from employment-like activities as labour income (though some commentators would disagree).

Although the arguments favouring different tax treatment of unearned/capital income and labour income are compelling, should these different forms of income be treated differently for income-splitting purposes? Some take the position that it is unfair to permit couples to minimise their combined tax burden by gifting income-producing assets to the lower-income spouse, but not to allow couples to split income from the family business. There are strong policy reasons based on the control or ownership model of income attribution, however, that justifies respecting unconditional gifts of income-producing assets between family members for tax purposes, but not permitting income essentially derived from the labour of one individual to be shifted to others. Other approaches for attributing unearned/capital income, including the Canadian attribution rules, are too difficult to administer, discourage a fairer redistribution of spousal assets, and/or undermine the privacy and autonomy of spouses with respect to their tax affairs. The control that goes with genuine ownership, on the other hand, has sufficient economic reality to warrant respect for tax purposes, is the only option that achieves true marriage neutrality and is consistent with both the attribution of labour income and choice of individual as the tax unit.

Situations involving mixed labour and capital income as well as income arising from the joint effort of two or more family members are more problematic. In mixed income situations, a Nordic-style dual-income tax (DIT) provides a principled method for separating the capital and labour components of business profits for both incorporated and unincorporated businesses in a way that does not rely on taxpayers choosing the form their income takes. Once the income has been dissected into its capital and labour components, the usual tax rates and attribution rules can then be applied. If the income is

the result of the joint efforts of two or more family members, the theoretically ideal approach is to attribute a portion of the income to each individual using a transfer pricing method, such as comparable uncontrolled price (which attempts to compare prices for services in a situation involving associated entities with prices charged between independent entities in comparable circumstances) or profit split (which divides profit generated by the joint efforts of associated entities based upon the relative value of the functions performed by each entity). This approach provides broad parity of tax treatment between associated and independent taxpayers. As in all transfer pricing situations, there will not be one unequivocal answer, but the result will be reasoned and workable and the compliance burden far lighter than full compliance with the UK domestic transfer pricing regime would require. Alternatively, a simpler ‘reasonableness’ approach as currently used in other jurisdictions, including the US and Canada in relation to partnerships, may be preferable to a transfer pricing approach.

As discussed at length in Chapter 5, the current UK restrictions on income-splitting—the ‘wholly and exclusively’ test, challenges to the validity of family partnerships, the settlements provisions—are inadequate. The employment-related securities rules may be of some assistance, but they have yet to be tested in the family-business context. The simplest and most egregious forms of income-splitting are limited to a degree in the present system, including paying excessive remuneration to family members and splitting partnership profits with minor children. In addition, the settlements provisions place limits on attempts to income split with minor children as well as spouses where dividends on preferred shares or dividend waivers are used.

Because the settlements provisions lack a transfer pricing or reasonableness element, however, they cannot address the form of income-splitting undertaken in *Jones v Garnett*.

Several possible reforms to the UK tax system to further restrict income splitting in family businesses can be made, as was discussed in Chapter 6. Expanding the scope of employment taxation by moving the borderline between employees/self-employed and employees/companies or by taxing dividends from small family companies may go some way in this direction. Maintaining the status quo, however, is also an option. Following the House of Lords decision in *Jones v Garnett*, the settlement provisions still have some teeth because the word ‘arrangement’ in the definition of ‘settlement’ is capable of broad interpretation and the common law bounty requirement does not appear to be a high hurdle for the Revenue to overcome so long as the arrangement at issue would not have been entered into by parties dealing at arm’s length. Spousal income-splitting arrangements involving ordinary shares remain viable, however, as do the tax arbitrage advantages from converting highly-taxed labour income into lower-taxed capital income.

Of the possible reforms discussed, in the short term, the addition of a transfer pricing or reasonableness test on dividends from family companies and allocations of family partnership profits to the spousal outright gift exception in the settlements provisions could reduce to some extent income-splitting arrangements involving family businesses that presently fall outside the scope of the provisions. Taking into account the relative contributions of the spouses to the business would help to address the current inequity in the rules that allows couples like Mr and Mrs Jones to minimise their tax

burden, undermining the control theory of income attribution and the choice of individual as tax unit in the process.

Furthermore, the rule in ITTOIA section 625 deeming spouses to have an interest in each other's property along with the spousal outright gift exemption in section 626 should be extended to include some unmarried cohabiting couples living together as husband and wife. As the Law Commission of Canada recommended, in cases where it is desirable to take into account a taxpayer's personal relationships—as with anti-avoidance legislation such as the settlements provisions—reliance on specific forms of relationship such as marriage should be eschewed in favour of a more comprehensive and principled approach to the legal recognition and support of the full range of close personal relationships among adults whether married/civil partners or living together as husband and wife/civil partners.

A major concern with the suggested short term reforms is if amending the settlements provisions will make compliance with an already uncertain regime too difficult for taxpayers, particularly small businesses with limited resources. Although the application in a given fact situation of a transfer pricing or reasonableness requirement in the outright gift exception will be somewhat uncertain, this has not proved to be a bar to the operation of similar rules in the US under the assignment of income doctrine and in Canada in relation to family partnerships. The uncertainty can be managed, over time, with appropriate HMRC guidance coupled with a small number of test cases. Moreover, whilst avoiding uncertainty is an important objective, some vagueness in law is inescapable and tax law in particular will never be completely certain. This is a reflection

of the nature of law generally and tax law specifically. So long as the rules adopted are not arbitrary and outcomes can be adequately predicted such that advisors can provide useful advice to guide clients' behaviour, blanket criticism that the amended settlements provisions will be 'too uncertain' should be met with a healthy degree of scepticism.

Amending the settlements legislation has the further advantage of minimising complexity and transition costs as compared to introducing an entirely new statutory scheme (such as that proposed by the Government in 2007 and subsequently withdrawn) to target income-splitting arrangements like that at issue in *Jones v Garnett*. Transitional issues and costs resulting from changes to the tax regime are critical aspects of ease of administration. As Raz argues, one of the more important principles that can be derived from the basic idea of the rule of law is that laws should be relatively stable. Stability is important because people need to know the law not only for short-term decisions but also for long-term planning. As the Meade Committee concluded 'an old tax is a good tax' in this respect. These reforms would not, however, address the non-neutral treatment of employment income versus business income generated from similar activities.

In the longer term, deeper structural reforms to the UK tax system could be made as well to enhance the neutrality of taxation of different legal forms (ie employment, unincorporated and incorporated businesses), which would go some way towards reducing the incentives to incorporate in search of tax savings, including tax savings from income splitting. Integration of the income tax and NIC regimes is one possible solution. Another option is to adopt a DIT that combines a progressive tax on labour income with a low flat rate of tax on income from capital. As long as the right balance is struck between

the tax rates on corporate profits, labour (including NICs) and capital, the DIT achieves level treatment between incorporated and unincorporated businesses, thus reducing the incentive to incorporate for tax reasons (and in the process reducing the scope for income-splitting). Finally, a tax avoidance approach such as a GAAR, or, more likely, a TAAR, is another option, although relying on anti-avoidance techniques to address deficiencies in the current legislation is less ideal than fixing those deficiencies directly

In summary, there does not appear to be any one simple solution to the issues raised by income splitting in family businesses. Each of the possible reforms considered in this thesis suffer from significant drawbacks. For example, amending the settlements legislation to better target a *Jones v Garnett*-type arrangement appears to be highly desirable on equity and neutrality grounds, but at the risk of making an uncertain regime even more uncertain for self-assessing taxpayers. It is perhaps unrealistic to seek to eliminate the equity and neutrality concerns raised by income splitting in family businesses altogether. Tax design must take into account a range of often conflicting factors, including certainty and administrative ease. A combination of the suggested reform options could provide at least a partial answer to this elusive problem. This result may be a compromise, but it is likely the best result that policy makers can hope to achieve.

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