



**THE
CHARTERED
INSTITUTE OF
TAXATION**

CIOT/ATT East Midlands Branch

“Tax Planning for Owner Managed Businesses”

**Presented by Chris Jones BA CTA (Fellow) ATT
Director Tax Training at Lexis Nexis**

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Venue:

The Novotel – Notts/Derby
Bostock Lane, Long Eaton
Nottingham

Timetable:

4pm – Refreshments and registration*
4.30pm – Lecture begins
6pm – Break for refreshments*
6.30pm – Lecture begins
7.45pm - Questions
8pm – Close

CPD Hours: 3

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TAX PLANNING FOR OWNER-MANAGED BUSINESSES

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1. Use of a Corporate Structure

1.1 Introduction

Since the introduction of the 0% rate of corporation tax in 2002 coupled with the abolition of stamp duty on transfers of goodwill it has been widely reported, and dare I say, acknowledged, that the optimum structure for anyone starting in business is the creation of a small limited company.

However, the introduction of the non-corporate distribution rate followed by the ultimate demise of the 0% rate has led to a modification of this advice. The current “general approach” is to begin trading through an unincorporated vehicle and then transfer the business operation to a new limited company after two years have elapsed and profits exceed say £40,000. This I explore further in the second chapter of these notes.

One must be extremely careful about adopting a “one size fits all” approach as clients are individuals as indeed are tax inspectors! What may work well for one may not work for another and it is my intention in this course to explore the full implications of any advice that we may give and to avoid the vast number of land mines that litter both current and proposed tax legislation.

In this first chapter I will explore the first hurdle that must be cleared to even consider the use of a small company, the application of IR35 and linked closely with that, the managed service company legislation that came onto the statute book in the Finance Act of 2007.

1.2 Recent cases on IR35

1.2.1 First Word Software Limited v Revenue and Customs Commissioners

In 1995 A established First Word Software Limited to provide computer consultancy services to clients.

On 1 September 2000 P entered into an agreement (“the 2000 agreement”) with First Word Software Limited under which it was agreed that P would pay them for supplying specified services to R.

The case

First Word Software Limited:

- could assign the obligations and benefits of the agreement so long as R were satisfied with the assignee, although in practice there was no substitution.
- would retain ownership of all intellectual property rights in all documents etc provided or created by it

The agreement stated it was to commence on 4 September 2000 and was to run until completion of the project, although it could be terminated at any time by mutual consent.

A attended R's London office where he was provided with a desk and a computer, an email account, and a security identity card identifying him as a contractor. He had no interaction with the UK management, sending a manager in Geneva his weekly progress updates, and he did not ask permission to take holiday. The appellant submitted weekly time sheets recording A's hours (countersigned by an R employee), together with an invoice, to P. A also worked from home and on the train on the R project using the appellant's computer, although he did not invoice P for those hours. A was identified as a contractor in R's telephone directory; he did not receive holiday pay, sick pay or pension pay and insurance for professional indemnity, public liability and employer's liability was held by the appellant.

From mid-2001 there were problems with P, who subsequently became insolvent, and the appellant's invoices were paid late. The 2000 agreement ended on 31 January 2002 when the project "went live" and the appellant no longer trades.

On 14 July 2006 the Revenue issued three decisions determining that the appellant was liable to pay PAYE and national insurance contributions (NICs)

The appellant appealed.

The findings

The authorities established the principle that whether a person was employed under a contract of service, or whether he was self-employed and provided a contract for services, was a question of fact in each case to be determined having regard to all the relevant circumstances.

Relevant factors could be:

- (1) whether the worker had to provide his own work and skill or whether he might substitute the work and skill of another;
- (2) whether the worker was subject to "a sufficient degree" of control;
- (3) whether there was mutuality of obligation so that there was an obligation on the worker to work and an obligation on the other party to pay him and to continue to make work available during the time of the contract;
- (4) whether the worker was in business on his own account-for instance did the worker have to provide at his own expense the necessary plant and material, hire his own employees and provide and maintain his own tools and equipment; did he invest in the enterprise and bear the financial risk; did he have the opportunities of profit or the risk of loss; and did he engage himself to perform services in the course of an already established business of his own;
- (5) whether the worker was paid by reference to the volume of work done; and

- (6) the duration of the particular engagements and whether the relationship was permanent and the number of people by whom the individual was engaged.

Substitution

Although A did do the work personally, the intention of the parties was that A was not obliged to do so as, under cl 6.3, the appellant could assign the obligations and benefits of its agreement with P.

Sufficient degree of control

It was clear that A acted as a sub-contractor with responsibility for part only of a larger project and not as an employee. He was engaged for his specific expertise and for a particular project. A decided how that project was to be undertaken, the means to be employed in doing it and when it was to be done. He worked at R's office and also on the train and at home and, whilst A sent updates to Geneva, the evidence was that that manager did not control A in the way that an employer controlled an employee, even a senior professional employee.

Mutuality of obligation

On the facts if A had been unable to work on the project then R were not obliged to find him other work or pay him, or to make work available for him.

Risk and in business on his own

It was relevant that A provided his own computer for work on the train and at home. A had invested in his own enterprise by establishing the appellant and after his work with R he ceased to be in business on his own account. During his time with R he had some financial risk of unpaid invoices and bad debts because P became insolvent. Both before and after his work for R, A had the risk of an insufficient number of engagements and although he was given work throughout the agreement with R, he might not have been.

Other factors

Turning lastly to volume of work done and other factors, A was paid an hourly rate, his relationship with R was not permanent and would terminate when the project was completed. He could have worked for others whilst working for R, he did not receive holiday pay, sick pay or pension benefits and R did not treat him like an employee. Finally cl 9 of the agreement provided that A brought his own expertise and intellectual property rights to the project and retained ownership of them and he also retained ownership of the processes he devised for the purposes of the project. Accordingly all those factors led to the conclusion that A would not be regarded as an employee of R. It followed that the appeal would be allowed.

Appeal allowed.

1.2.2 M K M Computing Ltd v Revenue and Customs Commissioners

Martin Ellwood is the sole director of, and owner of 50 per cent of the shares of, MKM Computing Ltd ("MKM"). In September 1998 the Appellant agreed to make Mr Ellwood's services available to Proactive Appointments Ltd ("Proactive") a company engaged in the business of making contract workers available to its clients. Proactive agreed with London General Holdings Ltd ("LGL") to make Mr Ellwood's services available to LGL. Mr Ellwood rendered his services as a contract analyst programmer for the benefit of LGL under these arrangements. The arrangements continued as the result of a number of extensions until 2002.

There was no evidence that MKM had undertaken any other material activity in relevant period other than providing Mr Ellwood to Proactive. MKM had no other employee with Mr Ellwood's skills.

On 11 June 2004 the Respondents made a Decision and two Determinations under the IR 35 legislation. They concluded that the circumstances were such that had Mr Ellwood been directly contracting with LGL the nature of the arrangements would have led to the conclusion that he was an employee and accordingly that, under the IR 35 legislation the Appellant was liable to NI and PAYE.

The appeal

For the relevant periods the legislation relating to direct tax was contained in Schedule 12 FA 2000. It provided so far as relevant to this appeal that where an individual or an associate receives from an intermediary (it is agreed that the Appellant is an intermediary for those purposes) or has rights to receive from an intermediary a payment or benefit not taxable under Schedule E then the intermediary is to be treated as making a payment chargeable to Schedule E of the amount of that payment or benefit. The provision apply where para 1(1) Schedule 10 applies.

Mr Ellwood personally performed services for the purposes of LGL's business but had no contractual relationship with LGL. His services were provided under arrangements involving the Appellant and Proactive. Each of them were third parties.

However, if the services were provided under a theoretical contract directly between the client and the worker, the worker would be regarded for income tax purposes as an employee of the client. It was this condition which was in dispute in the appeal.

Control

Once Mr Ellwood had been given a project he would get on and do it. He was not subject to detailed orders as to how to do what and when. But he was part of a team: he reported his progress to Mr Jarrett or other project managers and discussed what he was doing with other members of the team. Although these interchanges did not consist of giving orders it was clear to the commissioner that they would have affected what he did, when he did it, and how he did it.

At a very minimum a hypothetical contract between Mr Ellwood and LGL would have required Mr Ellwood to report his progress regularly to persons at LGL, to discuss with such person the content and progress of his work, and to co-operate with them and to adapt the course of his work so as to ensure the most effective progress of the work he was doing as a result of those consultations and discussions.

If Mr Ellwood wished to take an unscheduled holiday he would discuss it with the relevant personnel at LGL. Indeed there had been an occasion when he been refused a day off when they had been really up against a deadline.

Substitution

Before the commencement of the first contract Mr Ellwood was interviewed by a member of LGL's staff. There was a signed document that said that "[MKM] has the right to provide a substitution worker in addition to or in place of Martin Ellwood.....'

The commissioner's conclusion was that LGL's management regarded the arrangement it had with Proactive as being for the supply of Mr Ellwood's services only. That was whom they interviewed, and whom later they knew: that was who they thought they would get. Whilst they would consider any proposed substitute they did not regard themselves as being bound to do so, and even if a proposed substitute were interviewed and found acceptable they did not regard themselves as bound to accept him

If the arrangements had been incorporated into a contract between Mr Ellwood and LGL there would have been no provision under which Mr Ellwood could provide a substitute for his own personal service unless Mr Ellwood was unable to work for LGL and LGL approved the substitute in advance.

Mutuality of obligation

There was no obligation to renew any of the contracts at the end of their respective terms. But that is not relevant to whether there was mutuality during the period of each fixed term contract. However, during each fixed term Mr Ellwood would have been obliged to work and LGL would have been obliged to remunerate him.

The commissioner concluded that there would have been no obligation to provide work for Mr Ellwood but that there would have been an obligation to pay if work was not available.

Other factors consistent with a contract of service

Had the contract been simply for the delivery of a particular project - the development, the code, and the implementation that it could have been inconsistent with a contract of service. But it was not, it was for expert time to be spent in the development and delivery of the project. Mr Ellwood was not in the position of a painter engaged to paint a room; he was in the position of a painter employed to paint such parts of the house as his employer would from time to time require.

Business Risk

Like an employee Mr Ellwood was financially dependent upon one payer. Whilst by working a few extra hours Mr Ellwood could earn more, the scope for extra work was limited. Mr Ellwood was at risk if his work was substandard and there was an occasion when he worked uncharged for hours to remedy a defect. A professional employee he accepted might also work unpaid overtime to remedy a defect, but overall these factors pointed gently away from employment but not vigorously so.

In business on his own account?

Do these financial considerations, the short term nature of the contracts and the other circumstances point towards Mr Ellwood being in business on his own account if engaged under the notional contracts? In the commissioner's view they do not. Mr Ellwood would have had little opportunity to increase his profit and was not conducting any form of undertaking. His position was quite different from the mixer in *Lorrimer*: he worked for one company only for a succession of engagements over many years.

Equipment and expense

Mr Ellwood's work was mainly on LGL's computer. It had to be. This factor is neutral. A laptop was provided by MKM in 2002 - towards the end of the period under appeal - and it paid for Mr Ellwood's continuing education. These factors together point somewhat away from employment but not substantially.

On the other hand when Mr Ellwood worked in Australia his travel costs were met by LGL. It would, Mr Whittaker says not be unusual to pay a decorator for the wallpaper he uses in what would clearly be a contract of service. The commissioner also noted that a professional firm may charge its clients separately for specific out of pocket expenses. Overall the commissioner found that in relation to that project this indicator did not point towards employment but did not point strongly towards self employment.

Conclusion

The commissioner had the impression that while he was working at LGL Mr Ellwood was part and parcel of the organisation. Although a contractor, he sat alongside other members of staff discussed future projects, and was called upon for help in emergencies and worked along with them on the projects as would a permanent employee. The Commissioner was convinced that under a notional contract Mr Ellwood would have been an employee.

Case dismissed.

1.2.3 Datagate Services Limited v Revenue and Customs Commissioners

This is another IR35 case. The Parties agreed that the point at issue is whether, had the arrangements taken the form of a contract between Mr Barnett and MBDA, Mr Barnett would have been regarded as an employee of MBDA.

Findings of Fact

- (1) Mr Barnett is a person with wide experience of the design and development of computer software.
- (2) Mr Barnett is the sole director and shareholder of Datagate. It is a closely held company under his control. He has no written Contract with Datagate.
- (3) Datagate was incorporated on 2 February 1999 and began trading on 29 March 1999. The accounts describe its principal activity as computer consultants.
- (4) Datagate entered into a contract with Technology Project Services International Limited (“TPS”).
- (5) The terms of this contract, an hourly rate plus VAT invoice.
- (6) Clause 8 provided so far as relevant:

8.1 This Contract is a contract for the provision of Professional Consultancy Services; the relationship governed by this contract is neither that of agent-principal, nor that of the employer-employee. Any Consultants provided by you are and will remain employed by you; they are not employed by us, and during this Contract will not be employed by the Client. ...

8.5 This Contract is not exclusive, and you and your Consultants are and remain at liberty to also provide services of third parties.
- (7) Clause 9 of the Contract restricted the provision of services to the Client other than through TPS for a period of six months. I find that this was not a restriction of a type normally found in an employment contract.
- (8) TPS had an arrangement with MBDA for the supply of services.
- (9) TPS entered into the initial arrangement on 10 January 2001 which ended on 10 April 2001. The arrangement was extended until the 30 September 2004.
- (10) Work had to be carried out by a particular person because of security.
- (11) There was no provision for a minimum number of hours to be worked. There was also an ability to take time off.
- (12) There was a right to provide a substitute so long as suitable security clearance was obtained.
- (13) Mr Barnett could arrive when he liked. He could leave when he liked. He tended to arrive after 0930 hours and leave before 1600 hours so as to suit his lifestyle.
- (14) Mr Barnett could take time off when wanted to but out of courtesy discussed it with the team leader.
- (15) Mr Barnett worked with the relevant team but was provided with discrete sections of work. MBDA wish to learn from him.

- (16) I find that Mr Barnett's relationship with the MBDA team was that of a professional consultant providing independent services when looked at as a whole.

Findings

The commissioner does not consider that there was an ultimate right of control on the part of MBDA of the type the Manual implies. The engager MBDA could have continued with the engagement had it chosen to, or chosen not to renew the engagement. The position was not one of an ultimate right of control as would be the case of an employee. Even if there were I do not consider in the particular circumstances that this would be of the same nature as for an employee. If there was an ultimate right of control this was because of the security requirements and not anything akin to that under employment law.

There is nothing in the documents requiring personal service.

The documentation allowed for a substitute to be provided.

The equipment and materials were provided by MBDA but given the security context it would have been surprising had it been otherwise.

The requirement that the worker has a real risk of financial loss is somewhat circular. If the worker is in business on his own account there must be a risk of financial loss. Here, he risked not being continued to be engaged.

Mr Barnett was able to profit from sound management by organising his work effectively so as to save himself time and give himself more free time which he had told me was part of the reason that he organised his work in the way that he did.

The basis of payment was a fee basis. This is entirely consistent with self employment. On the evidence before me there was no employee type benefit such as sick pay or pension provisions.

There was no requirement that Mr Barnett work exclusively for MBDA.

Whilst the position was that Mr Barnett was engaged in assisting MBDA's business, he was not "integrated" as an employee in the way that the Tort cases sometimes suggest. There was evidence that MBDA sought to give him specific projects which so far as possible were self contained.

The engagement could be terminated but this was not the equivalent of being able to give notice under a contract of employment.

The commissioner does not find that the number or continuation of employment gives rise to employment status.

The intention of the parties seems to have been that there should be no employment. Why else would this structure have been set up?

The commissioner found that Bret Barnett was in business on his own account and was not a person working as an employee in someone else's business on the hypothetical requirements that the legislation requires. He chose to do this through his company.

Accordingly, the appeal is allowed.

1.2.4 Taxpayer loses in *Dragonfly Consultancy* - what does it mean?

Employment status continues to be an issue that fills up court time. The case of *Dragonfly Consultancy v HMRC* received a lot of publicity when it was heard at the Special Commissioners and in itself was a good case to read if you wanted to get up to date on recent employment status cases, plus older ones that still have a relevance (see SpC 655). The facts were based around the controversial IR35 (intermediaries legislation) rules. The case has now reached the High Court [2008] EWHC 2113 (Ch). although once again the taxpayer has lost.

The facts

Dragonfly Consultancy Ltd employed its owner, an IT consultant. Dragonfly contracted with an agency, which in turn had a contract to supply workers to an end client (the AA). The Special Commissioners held that had the consultant been in a direct contractual relationship with that client it would have been an employment relationship. Therefore IR35 applied. Dragonfly appealed.

In dismissing the appeal the Court made some interesting comments. Firstly, it found that the Special Commissioners were entitled to find that the substitution clause in the consultant's notional contract with the client would not have been such as to preclude an employment relationship. The substitution clause retained the right for the client to reject substitutes. The High Court also held that the Special Commissioners were entitled on the facts to hold that the degree of control exercised by the end client equated to that under an employment contract and the taxpayer had not provided sufficient evidence otherwise. Dragonfly Consulting is left facing a tax bill for £99,000.

Analysis

This case has been long awaited and there are strong views on either side about the facts. Some would argue that there was limited evidence that the taxpayer was really working on his 'own account' and others contend that he was patently distanced from the AA and working for himself. However, what is clear is that the facts as brought out failed to convince the Special Commissioners and the High Court that the taxpayer was outside of IR35.

One element of this was the inability of the taxpayer to show that he had a genuine substitution clause and it once again shows that although it is not technically essential, it certainly helps if those with such a clause in their contract use it on at least one occasion to show that it is capable of being used.

At the Special Commissioners decision in *Dragonfly Consulting Ltd* the following were the types of issue that may be relevant in determining IR35 questions:

- (a) does the taxpayer provide his or her own equipment?
- (b) does the taxpayer hire his or her own helpers?
- (c) what degree of financial risk does the taxpayer bare and what opportunity for profit does the taxpayer have?
- (d) what degree of responsibility for investment and management does the taxpayer have?
- (e) is the taxpayer part and parcel of his or her 'employer's' organisation (see *Hall v Lorimer*);
- (f) the **degree** of control to which the taxpayer is subject (rather than the mere existence of a right of 'control');
- (g) termination provisions – termination on notice may be a pointer towards employment in some cases (it was found to be so in *Morren v Swinton* (1965) 1 WLR 576 but found to be neutral in *McManus v Griffiths* 1997 70 TC 218);
- (h) the intention of the parties.

1.3 Managed service companies

Section 25, Finance Act 2007 introduces the Managed Service company legislation, but simply refers to Schedule 3 of the Act, and provides for an early commencement date, deeming the changes to have commenced on 6 April 2007.

1.3.1 Technical summary

Schedule 3 introduces a new Chapter 9 into Part 2 of ITEPA 2003, following Chapter 8, which deals with the taxation of services provided through intermediaries, otherwise known as IR35.

Chapter 9 creates a tax charge on income now regarded as deriving from an employment by virtue of para 2, which adds amounts treated as earnings of workers provided by managed service companies to the definition of employment income in ITEPA 2003 s 7(5).

Paragraph 3 excludes managed service company workers from Chapter 8, so workers taxed under the MSC legislation are statutorily excluded from IR35. Thus the MSC legislation replaces IR35 for income of affected workers. This is significant in two respects: the calculation on the deemed employment payment differs, and the debt transfer provisions which apply to tax due under MSC rules only.

Paragraph 4 of the Sch contains new Chapter 9 of Part 2 of ITEPA which runs from new ss 61A to 61J as follows:

Section 61A sets the scope of the Chapter as applying to the provision of services by managed service companies, but excludes the Chapter from applying to agency workers or foreign visiting performers taxed under existing s 966 (3) and (4) of ITA 2007.

1.3.2 Definition of MSC

New Section 61B defines managed service companies in two stages:

Subsection 1 sets out the main criteria of a managed service company, in four elements. The company (including, by virtue of s 61C(3) any body corporate or partnership) :

- provides the service of individuals
- who are paid the income arising from their services more or less intact,
- in such a way as the tax and NIC burden is less than that which would apply to employment income.
- finally “a person who carries on a business of promoting or facilitating the use of companies to provide the service of individuals” (a scheme provider) is involved with the company.

The term “involved with” is further defined. One key aspect of this legislation is that many service companies, whether potentially caught by IR35 or not, would satisfy the first three criteria, and it is the involvement of the MSC scheme provider that brings the company within the scope of the legislation.

1.3.3 Scheme provider

The definition of a scheme provider is therefore regarded as crucial, and the definition here excludes persons who merely provide legal or accountancy services in a professional capacity, and businesses which are pure employment and recruitment agencies; the exemption for the latter is somewhat convoluted to permit agencies some small influence over companies they place.

It is anticipated that these exclusions will be sufficient to target the legislation only at the known scheme providers, and not cause any unwanted effects on firms of accountants, tax advisers and lawyers. In any event, the term “involved with” which is defined in new s 61B(2) should ensure that professional firms are not affected in spite of concerns about the definition. There are powers to specify further descriptions of persons deemed not to fall within the definition of scheme provider by order in s 61C(1).

A scheme provider is involved with an MSC if the provider or an associate of the provider :

- Benefits financially on an ongoing basis from the provision of services of the individual, or

- Influences or controls the provision of services, the way in which payments are made to the individual or his associate, or the company's finances or activities, or
- Gives or promotes an undertaking to make good any tax loss.

Section 61C extends the concept of associate for these purposes to anyone who acts in concert with the scheme provider and others to ensure that the service of an individual are provided through a company, and provides an explanation of the term “undertaking to make good any tax loss” which thus extends to situations where the MSC provider insures some or all of any tax loss suffered.

This level of control or influence is likely to go beyond the advice and services provided by the average professional firm, even where it might be regarded that the level of support goes beyond the normal level of “accountancy services” provided to these businesses. It is important to recognise that the test of involvement only applies when it has already been established that there is a scheme provider present.

The amendments proposed in Committee sought to clarify the exclusions for accountants, tax advisers, company secretarial service providers and similar still further, but the Government was not willing to modify the legislation in this respect.

The Minister indicated that the amendments sought would not make progress towards clarification, and could introduce confusion. He was also concerned that the amendments would also provide scope for the real targets of this legislation to avoid its impact. The clarification offered by the Minister (HC Finance Bill Public Bill Committee (15 May 2007 pm) cols 175) made it clear that even where there was concern that firms of accountants might fall foul of the definition of MSC provider the concept of influence would go much further than the mere providing of advice, which permits the client to make a choice between appropriate courses of action. It would only be when the client is offered a standard solution or product which he accepts that the involvement would extend to influence. He then went further to state quite categorically that even where the specific exclusion for accountants does not apply, the purpose of the legislation is not to include within the definition of MSC provider accountants, tax advisers, lawyers and company secretaries who provide advice or other professional services to companies in general. Those persons are not in the business of promoting or facilitating the use of companies to provide the services of individuals, nor are they regarded as involved with the company in the way in which the legislation envisages. (HC Finance Bill Public Bill Committee (15 May pm) cols 175, 176).

1.3.4 Deemed employment income

Section 61D deems amounts paid to the worker – the person performing the services through the MSC – to the extent not already charged to tax as

employment income to be earnings from an employment at the time of receipt. The amount so deemed includes any payment or benefit made to the worker or his associates by any person which can reasonably be taken to be in respect of the services provided, which are now referred to as “the relevant services”.

Section 61E provides the computation of the deemed employment payment, which differs in detail from that performed under the intermediaries legislation. Starting with the amount of the payment or benefit which is the subject of the deeming provision, there are first deducted amounts met by the worker which relate to expenses deductible by employees, construing the relationship between the worker and the end user client as one of employment.

The remainder (if any) is treated as an amount including employer’s national insurance contributions, and thus the deemed employment payment can now be arrived at. Sub-ss (2) to (5) provide various other qualifications regarding the deductible expenses, allowing partnership expenses met by the worker to be deducted if the MSC is a partnership, and providing a deduction for mileage allowance relief for a car provided by the MSC or the partnership for the worker. The legislation seeks to put the worker in precisely the same tax position as if he had been employed by the client, but of course he will ultimately bear the employer national insurance contributions on the sums paid to him through his MSC.

Section 61F continues the analogy with the position of an employee, by defining payments and benefits for this purpose as any amount that if received by an employee for performing the duties of an employment, would be general earnings from the employment. The section provides valuation and timing rules for benefits which mirror the normal benefit code and timing rules in ITEPA.

Section 61G explains how the deemed employment payment is treated for income tax. In particular it brings the deemed payment within the scope of PAYE provisions, and excludes any deduction from the deemed payment in respect of mileage allowance relief or other expenses – relief having already been given in the computation of the deemed payment.

The deemed payment is excluded from tax on the worker when his circumstances match those of an employee of the client who would not be taxable on earnings from the employment. The deemed payment is not treated as income of a partnership of which the worker is a member, and finally under sub-s (7) the MSC is treated as having a place of business in the UK when the worker is resident here and the services are performed here, thus keeping the MSC within the PAYE responsibilities applying to UK businesses.

There are no other provisions in Part 9 which relate to the application of PAYE to the deemed payment, as having triggered the normal PAYE rules, no further separate legislation is needed.

Section 61H provides relief from income tax, on a claim by an individual, for distributions made by companies within the MSC legislation which have been treated as making deemed payments. The imitates the relief available in similar circumstances under the intermediaries legislation, and reduces the taxable amount of the distribution (and the related tax credit) when matched with deemed employment payments.

Sections 61I and 61J provide interpretative background and definitions; of particular importance is the definition of an associate in s 61I which includes as associates of a partnership, associates of members of the firm. (S61I(4)).

1.3.5 Debt transfer provisions

The debt transfer provisions are perhaps the most controversial aspect of this legislation. Paragraph 6 of Sch 3 inserts new s 688A into ITEPA 2003 to provide the statutory machinery for the debt transfer provisions. These provisions will allow HMRC to collect PAYE and NIC due under the MSC provisions from third parties if the MSC fails to pay the liabilities.

Essentially, the new section is enabling legislation allowing the detail to be prescribed by secondary legislation, amending the PAYE Regulations (the principal Regulations). These amending Regulations have been made and are SI 2007 No 2069. (For PAYE purposes).

Section 688A(1) allows amendment of the principal Regulations to authorise recovery from specified persons of any amount that an officer of HMRC considers should have been deducted by an MSC in respect of PAYE.

The persons specified for this purpose are given by s 688A(2). They include directors, office holders and associates of the MSC, MSC providers and a person who has encouraged or been actively involved in the provision by the MSC of the services of the individual. Finally, the provisions are extended to directors, office holders and associates of the last two categories. Although not within the body of the legislation, this aspect of the law will commence on 5 August for the first two categories of third party – directors, office holders and MSC providers, and from 5 January 2008 for the remainder. The debt transfer provisions apply only to PAYE debts arising from the commencement dates, not prior liabilities. It is anticipated that mirroring Regulations will apply to the National Insurance liabilities relating to the MSC legislation.

Subsection (3) provides an exclusion from these provisions for persons providing legal or accountancy advice (not services) and for employment agencies concerned solely with placing the services of the workers. This limited exclusion is narrower than that applying to the definition of an MSC provider, but it was considered that the requirement for the third party to have either encouraged or been actively involved in the provision of services through MSC's would sufficiently limit the application of these provisions. For example, it is unlikely that in most situations the client (end user of the services) would be a specified person; however this might arise where a client

actively promotes a scheme by transferring existing staff to MSC arrangements. (HC Finance Bill Public Bill Committee (15 May pm) col 190)

1.3.6 Deduction for deemed employment payment from profits

Part 2 of the Schedule provides exclusively for a deduction for the deemed employment payment in computing the taxable profits of the MSC. There are parallel provisions relating to MSC's tax under income tax rules, inserting s 164A into ITTOIA 2005, and similar provisions for MSC's liable to corporation tax on their profits. The corporation tax provisions stand alone, probably in view of the tax law rewrite project currently under way, rewriting the corporation tax code.

A deduction is provided in both cases for the amount of the deemed employment payment together with the employer's national insurance contributions paid by the MSC in respect of that deemed payment. In a similar way to the matching rules in the existing intermediaries legislation, the deduction is given in the period in which the deemed payment is treated as made. For income tax the deduction is restricted to an amount which would reduce the profits to nil, which is mirrored in the corporation tax provisions to the extent they apply to an MSC which is a partnership.

1.3.7 Secondary legislation

As expected, the secondary legislation was issued just after Royal Assent and is as follows :

- SI 2007 No 2068 – The Social Security (Contributions) (Amendment No 5) Regulations 2005 : these align the treatment of NIC's in relation to MSC's with the treatment of PAYE. They include provisions to identify the MSC related contributions due, when and how the debt may be transferred, to whom and the related time limits. It provides for interest on the transferred debt and rights of appeal.
- SI 2007 No 2069 – The Income Tax Pay as You Earn (Amendment No 2) Regulations 2007 : these implement the debt transfer provisions in relation to PAYE and are equivalent to the NIC provisions in SI 2068. (These were corrected by SI 2007 No 2296)
- SI 2007 Nos 2071 and 2072 – The Social Security Contributions and Benefits Act (Modification of Section 4a) Order 2007 and similar for Northern Ireland : Introduce powers to amend NIC's and enable regulations in relation to MSC's to be made.
- SI 2007 No 2070 – the Social Security Contributions (Managed Service Companies) Regulations 2007 : These Regulations introduce the charge to NIC in relation to earnings from MSC's, with effect from 6 August 2007.

In summary, the PAYE Amendment regulations provide as follows :

- A managed service company has a “relevant PAYE debt” if there is MSC tax due and this has not been paid – the regulations specify how this lack of payment is identified;
- If an officer is of the view that the relevant PAYE debt is irrecoverable from the MSC within a reasonable period, then a direction may be made authorising the recovery of the amount from another person, who then becomes jointly and severally liable for the debt;
- The Regulations then prescribe that notices may not be served on Section 688A(2)(c) persons or associates in relation to relevant PAYE debts arising before 6 January 2008. Nor may a notice be served on them unless it is impracticable to recover the debt from those listed in Section 688A (2)(a) and (b) or para (b) associates.
- Time limits, content of the notice of debt transfer and rights of appeal are also set out in the Regulations.

1.4 Self assessment tax return—service companies question

The guidance relating to the service companies question on page TR4 of the 2007-08 Self Assessment tax return for individuals has been revised.

We acknowledge that with hindsight the question on the tax return and original guidance were unclear, for which we apologise.

Since concerns were first raised, HM Revenue & Customs (HMRC) has been working closely with representatives of the Institute of Chartered Accountants in England and Wales (ICAEW) and the Chartered Institute of Taxation (CIOT) to make the text of the question and the guidance clearer. We are pleased to announce that as a result of that collaboration we have now developed—

- clearer guidance in the tax return guide which should be read when completing the 2007-08 Self Assessment tax return and tax returns for future years; and
- revised wording for the service company question, which will first appear on the 2008-09 Self Assessment tax return.

The amended guidance is reproduced below. HMRC will shortly update the 2007-08 tax return guide (SA150) on the Self Assessment returns part of our website to reflect the new text.

The text of the revised question for 2008-09 is also reproduced below for information.

If you have already submitted your 2007-08 Self Assessment return

If you have already submitted your 2007-08 Self Assessment tax return, you do not need to take any action as a result of these changes. There will be no

adverse consequences simply because you completed (or left blank) the question in a return filed prior to today's date.

Record keeping

It is not necessary to keep any additional records to determine whether more than half of the company's income was derived from services performed by the shareholders personally. Where the level of income derived from services performed by the shareholders personally is not readily discernable from existing records, best judgement should be used.

Updated guidance for 2007-08 onwards

Service Companies

Complete this box if you provided your services through a service company. You provided your services through a service company if—

- you performed services (intellectual, manual or a mixture of the two) for a client (or clients);
- the services were provided under a contract between the client(s) and a company of which you were, at any time during the tax year, a shareholder; and
- the company's income was, at any time during the tax year, derived wholly or mainly (that is, more than half of it) from services performed by the shareholders personally.

Do not complete this box if all the income you derived from the company was employment income.

Example

Services are provided through a service company as described above.

Salary received from the service company (before tax)		£15,000
from the service company		
Dividends received from UK companies (including tax credit)		
from the service company	£50,000	
from a shares portfolio	£ 5,000	£55,000
Total		£70,000
Amount to be entered (excluding the shares portfolio dividends) in the service companies box (box 1 on page TR4)		£65,000

Text of the revised question to be included on the 2008-09 Self Assessment tax return

If you provided your services through a service company (a company which provides your personal services to third parties), enter the total of the dividends (including the tax credit) and salary (before tax was taken off) you withdrew from the company in the tax year.

2. Incorporation and Disincorporation

2.1 Is it worth incorporating?

There are a number of changes taking place to income tax and corporation tax rate from April 2008, namely:

- The Small Company Rate increases to 21% from 1 April 2008 (and a further rise to 22% is planned from 1 April 2009);
- The main rate of corporation tax falls by 2% to 28% from 1 April 2008;
- From 6 April 2008 the 10% starting rate of income tax will be abolished and at the same time the basic rate will reduce to 20%.

So, with these changing rates in mind it is time to consider whether incorporating a sole trader into a limited company is now a worthwhile exercise. Indeed, we also need to ask whether we ought to start disincorporating clients that have already transferred their trade into a limited company.

2.1.1 Assumptions

In the company calculations I am assuming that profits will be withdrawn in the most tax efficient manner possible, by taking a salary to cover the personal allowance of **£6,035**, with the balance being taken as a dividend. I am also making the wild assumption that there will be no further changes to the tax system in the meantime!

Profits	Sole Trader	Company	Saving 2008/09
£10,000	£1,278	£953	£325
£15,000	£2,678	£2,003	£675
£20,000	£4,078	£3,053	£1,025
£30,000	£6,878	£5,153	£1,725
£40,000	£9,678	£7,253	£2,425
£50,000	£13,553	£10,191	£3,362
£75,000	£23,804	£20,378	£3,426

2.1.2 One Year On...

From 1 April 2009 the rate of corporation tax increases by a further 1%. Nonetheless, the table below reveals that in most cases incorporation is still a worthwhile exercise and I would therefore be surprised whether the incorporation rush in 2002 is going to be matched with a disincorporation rush seven years on.

Profits	Sole Trader	Company	Saving 2009/10
£10,000	£1,398	£1,004	£394
£15,000	£2,798	£2,104	£694
£20,000	£4,198	£3,204	£994
£30,000	£6,998	£5,404	£1,594
£40,000	£9,899	£7,604	£2,295
£50,000	£13,439	£10,394	£3,045
£75,000	£23,689	£20,769	£2,920

2.2 Is this the answer?

As I mention in the introduction to this course in paragraph 1.1, the “one size fits all” approach is dangerous as Rebecca Benneyworth points out in her article “*No easy answer to the incorporation question*” published last year in Tolley’s Practical Tax” which is summarised below.

Advisers to smaller businesses which took the opportunity to incorporate some years ago, when the rates of corporation tax were very low, have been faced with a dilemma since the 2007 Budget announcements. Not only has the rate of corporation tax risen this year, but it is due to rise further over the next two years. At the same time, for those making a relatively modest profit, the overall tax burden under the income tax regime will fall, as the reduction in the basic rate takes effect next year.

Comparing the tax saved on identical profits is one step to developing a strategy for advice, but this is by no means the end of the story. All of those advising smaller businesses will know that running a small business through a company often costs more than running the same business as a sole trader. These additional costs will need to be factored into any calculations to allow a straight comparison to be made. And given that we may be looking at those on the margin of tax credits, is there any difference in the position when the impact of a tax credit claim is taken into account?

2.2.1 Peter and Paul

To illustrate the position, we shall consider two businesses, run by twins Peter and Paul. Peter is a joiner and Paul a general handyman/gardener and they have been making identical profits each year.

Peter decided to incorporate his business some five years ago. Peter is disappointed about the increased corporation tax rates coming through for the next few years, and is now sitting down in the lounge bar of the Dog and Duck with Paul, trying to work out who is and will be better off.

Administration costs

Before considering the headline rates of tax, the twins decide to compare the profits which are subject to tax. Although they were both making £30,000 pa before motoring costs prior to Peter's incorporation, Peter's profit and loss account now shows a different cost base. His professional fees have risen fairly steeply, and he is now paying around £1,000 more a year than Paul for help with dividend minutes and vouchers, the company accounts and tax return and various other statutory requirements, including payroll, in addition to his personal tax return.

Peter was advised to keep his car out of the company when he incorporated, so the only motoring costs showing are the mileage allowance that he draws towards business motoring costs. He drives an eight-year old Ford Mondeo, travelling 6,000 miles a year for business, exactly the same as Paul. Peter's accounts therefore show a deduction for £2,400 which he draws from the company to pay for his business miles. So from a start point of £30,000, Peter's company's annual profit before director's salary is $(30,000 - 1,000 - 2,400) = £26,600$.

Peter extracts a salary of £6,035 and the balance by way of quarterly dividends.

Paul's sole trader accounts show a deduction for the actual cost of running the car for 6,000 miles a year. This amounts to 60 per cent of his annual mileage. The business element of costs other than fuel and depreciation is £720; fuel costs for business miles are 14p per mile, totalling £840, and capital allowances (business element) are currently £500.

Paul's accounts show a taxable profit after capital allowances of $(30,000 - 720 - 840 - 500) = £27,940$.

Assuming inflation does not affect either the profits earned or the costs borne by the brothers, their tax position over the next few years is as shown overleaf.

Peter — limited company		Paul — sole trader	
2008/09	£	2008/09	£
Company's profit before salary	26,600	Taxable profit	27,940
Salary + Ers NI of £77	<u>6,112</u>	Personal allowance	<u>6,035</u>
Taxable	20,488	Liable to tax and NIC	<u>21,905</u>
Corporation tax at 21%	<u>4,302</u>	Income tax at 20%	4,381
Net profit = dividend	<u>16,186</u>	Class 4 NIC	1,800
		Class 2 NIC	<u>120</u>
<u>Post-tax income</u>		Total tax and NIC	<u>6,301</u>
Salary less Ees NI of £60	5,975		
Mileage allowance	2,400		
Dividends	<u>16,186</u>	<u>Post-tax income</u>	
Total	<u>24,561</u>	Profit	30,000
		Less tax and NIC	<u>6,301</u>
		Net income	<u>23,699</u>
2009/10	£		
Taxable profit as above	<u>20,488</u>	All motoring costs are therefore borne out of post tax income by both brothers	
Corporation tax at 22%	<u>4,507</u>		
Net profit = dividend	<u>15,981</u>		
Post-tax income	<u>24,356</u>	2009/10	£
		Liable to tax and NIC (as above)	<u>21,905</u>
		Income tax at 20%	4,381
		Class 4 NIC	1,800
		Class 2 NIC	<u>120</u>
		Total tax and NIC	<u>6,301</u>
		Post-tax income	<u>23,699</u>

So, by 2009/10, the brothers have calculated that Peter will still have the advantage over Paul, in that his post tax income will be £24,356 as against Paul's £23,699. A saving of more than £650 per year, after paying for his accountant, satisfies him that the company is the right structure for him.

Tax credits

For tax credit purposes, in 2008/09 Peter has income of £24,019 (salary plus dividend and tax credit), and Paul has £27,940. This provides a further potential advantage to Peter of up to £1,529 (the income differential at 39 per cent). This tax credit advantage depends on the personal circumstances of the brothers, and to be of any relevance it is likely that the brothers would have to have three children, or be incurring childcare costs in respect of at least one child.

Motoring costs

Part of the reason that the company structure still provides a benefit is that the motoring costs are relatively modest. Running an older car means that the impact of depreciation is minimal, so the 40p per mile available from the company more than covers the running costs of the car, which are estimated at 34p per mile. If the car were a newer model so that depreciation was significant (and the insurance costs higher) the benefit could be reversed. A new Ford Mondeo would cost around 56p per mile to run, at which point Peter would be bearing an additional £960 per year in business motoring costs — which would then be borne out of taxed income and eliminate the benefit of incorporation completely.

2.2.2 Pamela

The brothers have a sister Pamela, who is a very successful businesswoman. She has always operated as a sole trader, as she prefers the flexibility that this gives her. Pamela is not keen on rules and regulations. She needs to travel extensively for business, and buys a brand new car every three years which is used at least 90 per cent for business purposes.

Although her capital allowances are restricted, Pamela benefits from a balancing allowance each time she changes her car, so that the cost of running the car attracts tax relief at Pamela's highest rate. Her profits are around £80,000 per annum before motoring costs, and she is surprised at the outcome of the brothers' discussions — she had believed that the days of incorporating to save tax were over after the 2007 Finance Act. She sits down with her brothers to look at her position over the next few years.

They tell her that the position is particularly complex for her, as the rules affecting the tax treatment of motoring costs are in a bit of a state of flux, but between them they have their 'best stab' at Pamela's tax position over the next few years.

Administration costs

They consider that Pamela's business is no more complex than Peter's, so they allow £1,000 pa for additional professional fees if the business converts to a limited company. It is possible that through the transfer of free goodwill to the company, Pamela can effectively isolate some capital gains, in respect of the value of goodwill transferred to the company, with an effective rate of tax of 10 per cent. The gain would be represented by a loan account on which Pamela can draw at will. However, leaving goodwill aside (the three siblings believe that in reality any goodwill in Pamela's business is personal and therefore not transferable to a company) they study the impact of incorporation on Pamela's motoring costs.

She is presently driving a BMW 3 Series diesel saloon, having purchased it this year for £24,000. It has emissions of 158g/km, giving rise to a potential benefit in kind of 21 per cent of the list price of £25,500. The average running cost per mile over the three years, including depreciation and fuel, is 53p per mile. Ninety per cent of the 12,000 miles per year that she travels are business miles.

As a sole trader, the profits she earns are reduced by the business proportion of the annual motoring costs. If she were to incorporate, she would need to consider whether the car should be introduced into the company, or retained in private ownership, so all three outcomes will be considered overleaf.

Pamela — sole trader		Pamela — limited company (+ car)	
2008/09	£	2008/09	£
Profit before motoring costs	80,000		
Motoring costs (10,800 miles)	<u>5,724</u>	Profit	79,000
		Motor expenses (100%)	£6,360
Taxable profit	74,276	less private fuel	£120
Personal allowance	<u>6,035</u>		6,240
Liable to tax and NIC	<u>68,241</u>	Class 1A NIC on car benefit	685
Income tax at 20%	6,960	Salary + Ers NI	<u>6,112</u>
at 40%	13,376	Taxable	65,963
Class 4 NIC at 8%	2,768	Corporation tax at 21%	<u>13,852</u>
at 1%	342	Net profit =	<u>52,111</u>

		dividend	
Class 2 NIC	<u>120</u>	<u>Post-tax income</u>	
Total tax and NIC	<u>23,566</u>	Salary net of NI	5,975
		Dividends	52,111
<u>Post-tax income</u>		Tax on car benefit	(1,071)
Profit	74,276	Higher rate tax on dividend	(6,267)
Less tax and NIC	<u>23,566</u>	Private fuel	<u>(120)</u>
Net income	50,710	Net income after motoring	<u>50,628</u>
Mileage costs borne privately	636		
Net income after motoring	<u>50,074</u>		

Pamela's conclusion is that she should remain self employed. The tax saving will leave her only £554 better off as and she prefers the flexibility of being self employed. However, the brothers indicate that she might consider leaving the car outside the company, bearing the costs privately, and drawing 40p per mile for the first 10,000 business miles a year, and 25p thereafter. Although these rules are presently under review, a short comparison follows for Pamela's benefit.

Pamela — limited company (private car)	
2008/09	£
Profit	79,000
Mileage allowance	4,200
Salary + Ers NI	<u>6,112</u>
Taxable	68,688
Corporation tax at 21%	<u>14,424</u>
Net profit = dividend	<u>54,264</u>
<u>Post-tax income</u>	
Salary net of NI	5,975
Mileage allowance	4,200
Dividends	54,264
HR tax on dividend	(5,736)
Motoring costs at 53p	<u>(6,360)</u>
Net income after motoring	<u>52,343</u>

Although this now shows a benefit in incorporating of around £2,270 for 2008/09, Pamela wishes to wait a little longer before making a final decision. She has doubts whether the benefit of less than £2,000 per annum will outweigh what she perceives as the lack of flexibility in being a limited company, and she has heard that in particular, the mileage rates are under review. Were the tax free rate per mile to reduce, or the number of miles at the higher rate to reduce, she could be significantly worse off, as her actual costs already compare unfavourably with the reimbursed rates.

2.2.3 Conclusion

It was the Government's clear intention to erode the benefit of incorporation by changing the rates of corporation tax, and when considering real business scenarios (rather than just comparing like for like profits) it would seem that this has indeed been achieved.

While there is still a reasonable margin of benefit at higher levels of profit, this can easily be eroded or even reversed by additional costs, particularly when the business runs a luxury car. Looking at the tax saving between self employment and car privately owned in 2008/09, the saving of £2,270 equates to a potential additional running cost of only 16p per mile (at 12,000 miles per annum) — a car costing 75p per mile to run would leave her better off as self employed.

2.2.4 The future

The introduction of the new annual investment allowance is tax neutral, as this will be available to all businesses, irrespective of legal form. However, it will have a significant impact on the tax credits available to a sole trader, as the allowance will be a deduction from income for a sole trader, but only a deduction from taxable profits for the company, and thus will not reduce declared income for tax credits.

Technical note: The running cost data for the Ford Mondeo were taken from data provided by the AA. Data in relation to the BMW was extracted from What Car magazine, New Car Buyers guide dated July 2007. Current rates applying to advisory fuel mileage rates and mileage allowance payments have been used. The impact of VAT has been ignored.

2.3 Some thoughts on disincorporation

Over the last five and a half years, a large number of unincorporated businesses have turned themselves into limited companies. Although the Government's attempt, through the operation of the non-corporate distribution rate, to discourage sole traders and partnerships (especially the smaller ones) from following this route was a failure, circumstances will still arise where a private company proprietor may wish to revert to his previous unincorporated status. If so, what are the tax implications of this course of action?

Any business proprietor heading for incorporation must understand that, effectively, he has a one-way ticket. All the tax considerations which need to be taken into account on an incorporation such as the cessation of trade, CGT and IHT also apply to a disincorporation. The problem is that, while there are reliefs to facilitate the transition on the way in, there is precious little assistance from the taxman for the exit route.

The most significant problem area is the treatment of capital gains. Ss162 and 165 TCGA 1992 are there to roll over or hold over gains arising on the incorporation of the business. Unfortunately, there are no equivalent provisions to deal with the liabilities on the way out. It should not be overlooked that these may be substantial, taking into account inflation, the development of the business inside the company and the fact that the underlying assets may have a low base cost because of the deferred gains when the company was originally incorporated.

The Government appear only to have paid lip service to the disincorporation dilemma. As one commentator has remarked:

‘Much of this stems from a time when the developing business would traditionally have headed for the corporate sphere and not the other way round. The need to move the other way was either not recognised or not considered significant.’

The last official comment of note came from the Financial Secretary to the Treasury in 2000 when it was recorded that the Government had no plans to change the tax rules applying to disincorporation.

The various disincorporation issues which need to be addressed include:

- the cessation of the company's trade;
- the position of any corporate trading losses;
- close investment company status;
- extracting the business as a going concern;
- extracting cash from the company; and
- winding up the company.

All this assumes a solvent company at the end of its useful life.

2.3.1 Cessation of the company's trade

The cessation of the company's trade will bring an end to the current corporation tax accounting period. This will normally advance the due date for paying any corporation tax owing for the final period.

Necessary computational adjustments will include a consideration of the price at which stock should be sold. There will also be a deemed disposal of all the plant and machinery, leading to a balancing adjustment for capital allowances purposes.

Disposal of the company's chargeable assets will often produce capital gains and this can lead to significant liabilities. The disposal will usually take place after the cessation of the company's trade. This precludes the offset of any trading losses which may have accrued in an earlier accounting period.

2.3.2 Corporate trading losses

If the company was making losses at the time when it ceased to trade, this will give rise to an additional problem. Trading losses for the final accounting period can be offset against any profits of the same period under S393A(1)(a) ICTA 1988. Any remaining losses can be carried back and set against the company's total profits of the three previous years – see S393A(2A) ICTA 1988. If that is insufficient, any unrelieved losses lapse. As mentioned in (h) above, they cannot be set against gains in a later accounting period nor can they be transferred with the trade to a successor.

2.3.3 Close investment company status

Once the company has ceased to trade, it is quite likely that it will become a close investment company. The main consequence of this is that any profits arising will be taxed at the full rate of 30%. However, by virtue of S13A(4) ICTA 1988, a company which was not a close investment company before it went into liquidation will not be treated as a close investment company for the

first accounting period following the commencement of the liquidation. If the liquidation lasts for more than 12 months, it will become a close investment company for second and subsequent periods. In practice, the company may well have ceased to trade before the resolution to wind it up was passed: in that case, the company would have been a close investment company in the immediate pre-liquidation accounting period and so it would stay as a close investment company for all remaining accounting periods.

2.3.4 Extraction of the business from the company

If the proprietor wishes to take the trade out of the company as a going concern, it is still necessary to consider all the effects of the cessation of trade provisions. Particular attention must be paid to the capital gains arising. The transfer of chargeable assets (including pre-1 April 2002 goodwill) from the company to the proprietor will be a connected party transaction, requiring the use of market value to compute the gains. However, in the absence of a third party sale, there will be no proceeds with which to pay the tax. This may influence the manner of the extraction.

If the company needs funds with which to pay any corporation tax due, this will almost certainly force the proprietor to buy the assets of the business from the company. In the speaker's experience, this is probably a situation which he will not have envisaged. Remember that the payment does not need to be the full market value (even though this will be used in order to calculate the gain) – it only has to be sufficient to leave the company with adequate resources to pay the tax.

Alternatively, if the company has enough cash to ensure that it can settle its own tax liability following the transfer of the trade, the business can be distributed in specie to the shareholders. This is a distribution under S209(4) ICTA 1988, which means that the shareholders will suffer higher rate income tax on the grossed up value of the business transferred. It should be noted that there is a double charge here: the company has a liability on its gains (as well as on any trading profit on the cessation of its trade) and the individual proprietor has a liability on his receipt.

Where the proprietor buys the business at an undervalue in order to provide the company with funds with which to meet its tax liability (see (1) above), it is understood that the excess of market value over the actual consideration paid will also be treated as a distribution under S209(4) ICTA 1988. The speaker has heard it suggested that this could give rise to a charge under S419 ICTA 1988, although this seems an unlikely scenario given that the transaction is a permanent transfer of the assets and not a loan.

2.3.5 Extracting cash from the company

If the company was adequately financed, there remains the problem, after the extraction of the business, of how to draw the remaining cash out of the

company. This is no different to the usual considerations and the outcome will probably be a straight choice between:

- a dividend; or
- a capital distribution on liquidation.

A dividend will be useful if the amounts are small and the shareholders are not higher rate taxpayers. In other cases, tax will be due at an effective rate of 25%. A capital distribution, on the other hand, may enjoy the benefit of business asset taper relief at 75% (for 2007/08) or entrepreneurs relief (from 2008/09), although this is likely to be diluted as a result of the cessation of trade. A capital distribution which is effected during the liquidation gives rise to a chargeable gain under S122 TCGA 1992. Any personal capital losses of the business proprietor as well as his annual CGT exemption can be set off against such a gain.

2.3.6 Liquidation and striking off

A formal liquidation of the company in these circumstances may prove to be a long and costly process. The members of a solvent company can proceed to wind it up, but this must be dealt with by a licensed insolvency practitioner.

The expense and complexity of a formal liquidation may seem excessive when dealing with a private company which is no longer required and which only has modest reserves. There is of course a far simpler procedure for dealing with an unwanted company. Under S1003 Companies Act 2006, the company may apply to the Registrar of Companies to be struck off the register. The directors of the company must meet the stringent company law requirements to notify all the shareholders, employees and creditors of their intention to invoke this process. In addition, the application cannot be made until at least three months have elapsed since the company ceased trading. The first move is to deal with the extraction of the business as described in (k) – (n) above.

Where a private company is dissolved under S1003 Companies Act 2006 without going through a formal winding up procedure, any pre-dissolution distribution is, strictly speaking, an income tax matter – the company has not technically ‘gone into liquidation’. Nevertheless, by virtue of ESC C16, HMRC are prepared in practice to treat such a distribution as a capital receipt, if the taxpayer wishes. This useful concession enables taper relief to be set against any gains resulting, but see Para CG17963A of the Capital Gains Manual for an explanation of the position of business asset taper relief in this situation.

Article by Robert Jamieson

2.3.7 Transactions in securities rules

The transactions in securities provisions now contained (for income tax purposes) in ITA 2007, Part 13 chapter 1 must always be

considered in relation to transactions involving the company's shareholders.

Even though the trade is being transferred into personal ownership, rather than a commonly-owned company, it is probably prudent to assume that HMRC would seek to counteract the tax advantage from the liquidation/dissolution (i.e. extracting the reserves in an income tax-free form as a capital receipt) under ITA 2007, s 684. However, provided it can be demonstrated that the disincorporation was motivated by sound commercial reasons, the normal let-out in s 685 should be available.

HMRC is likely to challenge those cases where they suspect the shareholders have only disincorporated to extract the company's reserves at a beneficial CGT rate, assisted by business taper relief.

On the other hand, where all (or substantially) all the company's funds need to be re-invested in the successor sole trade/partnership business, a more benign approach is likely to be taken.

The overall tax costs of the disincorporation may also be an important factor in HMRC's deliberations.

The shareholders will need to obtain certainty on the tax treatment of the capital distribution and should therefore apply for advance clearance under ITA 2007, s 701 that HMRC agree that the genuine commercial purpose test is satisfied.

3. Extracting Profit from a Small Company

3.1 Low salary, high dividend

For the past few years many family owned companies have chosen to reward owner managers by way of a “personal allowance” salary topped up with monthly dividends. For companies with profits below £300,000 this is an extremely tax efficient way of drawing remuneration.

When pursuing this method of extraction it is essential to get the paperwork right in respect of the dividends. Minutes and dividend vouchers will be required and should be produced on a timely basis.

The low salary could cause problems if the owner manager has a PHI policy which pays out a percentage of earnings when the policyholder is unable to work through illness or accident. The policy must be reviewed to ensure that it takes accounts of dividend income as well.

Do not forget that an employee, who is a worker under the terms of the National Minimum Wage Act, must be paid at least NMWA rates, so a salary equal to the personal allowance would not be possible wherever there is a full time employment contract. The director who is only an office holder under the Companies Act is not a worker under NMWA and this requirement is negated.

3.2 Larger companies

Where the company’s chargeable profits exceed £300,000 the marginal rate of corporation tax will increase. Based on the Chancellor’s Budget Day announcements the rates over the next three years will be as follows:

<i>Year</i>	<i>Profits up to £300k</i>	<i>Profits between £300k & £1.5m</i>	<i>Profits above £1.5m</i>
1.4.07 – 31.3.08	20%	32.5%	30%
1.4.08 – 31.3.09	21%	29.75%	28%
From 1.4.09	22%	29.5%	28%

In light of this, tax deductible methods of profit extraction often prove more beneficial in order to reduce the chargeable profit to £300,000 (or whatever small company limit applies to the individual company). Rental income and loan interest do not attract national insurance liabilities and are often worthy of consideration.

Changes Associated companies rules

The Budget 2008 announced changes to the associated company rules which may result in less companies falling outside the small company limits.

Changes will be made to the associated companies rules as they apply to the small companies' rate of corporation tax. The changes will amend the definition of 'control', solely for the purposes of SCR, to ensure that the rights or powers held by business partners will be attributed only when there have been tax planning arrangements involving the shareholder or director and the partner to secure a tax advantage by virtue of greater relief under the SCR rules. These changes will apply with effect from 1 April 2008.

3.3 Salaries and benefits

Salaries create significant national insurance liabilities for employer and employee thus negating any corporation tax saving.

Many small company directors are appointed office holders under the Companies Act. They may perform extensive duties for the company in this capacity. Remuneration is by way of a fee, the level of which may be determined from time to time and is normally approved by the members of the company (the shareholders, who may be the same individuals acting in a different capacity) at the annual general meeting.

In such a case, there is no reason why the level of the fee should not be set at (say) £40,000 this year but only at the personal allowance next year. Such fees are employment earnings subject to deductions of tax under PAYE and NIC.

Although it is unusual in small family companies, some directors may have a separate employment contract. The terms of such a contract will include the payment of a salary, usually agreed in advance.

Ordinary (i.e. non director) employees must have an employment contract even if only implied and covering the bare minimum rights under the Employment Protection Act. A salary will be set in advance.

Where an employment contract exists, the employer cannot unilaterally alter the terms of it. The employer and employee might agree to vary the terms which could involve reducing the salary. This has a disadvantage in loss of flexibility. The salary would be fixed at a lower level.

3.3.1 Waiver of salary

The better alternative is that the employee (whether director or not), being entitled to a certain salary, formally waives part of it. The amount waived could vary from year to year, bearing in mind that the employee could want a higher salary occasionally.

So, what does a salary waiver entail?

There is extensive coverage of this topic in the Revenue Manuals, especially at SE42700-42786. This distinguishes waivers from sacrifices.

The Revenue takes a waiver to mean an employee giving up rights to remuneration and getting nothing in return.

A sacrifice, on the other hand, is where the employee gives up rights to remuneration in favour of a benefit.

The position of dividends is not mentioned.

A dividend cannot be in substitution for a waived (or sacrificed) salary. Entitlement to salary is in respect of a director's (or employee's) employment contract. A dividend is paid in respect of a member's shareholding and may fail if the company has insufficient distributable reserves.

To be valid for tax purposes, the entitlement to remuneration must be given up before it is treated as employment earnings. Once the director or employee is treated as receiving cash emoluments:

- income tax is due under PAYE and NIC must be accounted for;
- he is liable to tax on employment earnings; and
- the employing company is entitled to a deduction in the computation of the profits of its trade.

An individual is treated as receiving emoluments at the earliest of the following (ITEPA 2003, s18):

- when actual payment is made;
- when the person becomes entitled to payment;
- where the person is a director and sums on account of the emoluments are credited in the company's accounting records;
- where the person is a director and the amount of the emoluments is determined before the accounting period ends, the end of the accounting period; and
- where the person is a director and the amount of the emoluments is determined after the accounting period has ended, the time when the amount is determined.

If any of these events has passed, any cash payment is treated as employment earnings. Note that the Revenue takes the view (at least for an ordinary employee) that entitlement to salary accrues on a daily basis.

Therefore waiver of remuneration must take place before the earliest event which causes it to be treated as taxable. If this is the case, then the Revenue should not be able to argue that any subsequent amount (e.g. a dividend) is remuneration.

There is anecdotal evidence that, in cases where directors have hitherto enjoyed a large salary but now take a small salary plus a dividend, then Revenue Employer Compliance Teams are seeking to treat the dividend as if it

were a salary. From the foregoing, this should not be the case where a waiver is properly executed. Unlike a dividend waiver, there appears no necessity for a Deed of Waiver but some form of written document seems essential.

3.3.2 Car benefits from 2008/09

The car benefit charge for a full year is obtained by multiplying the price of the car for tax purposes (in most cases, its list price plus accessories less capital contributions) by the 'appropriate percentage'.

The rules governing the calculation of the appropriate percentage change in three ways with effect from 2008/09.

- The lower threshold, the CO2 emissions figure which determines the appropriate percentage for all cars, is reduced from 140 to 135.
- A new '10 percent band' is introduced for cars with a CO2 emissions figure of exactly 120 g/km or lower, the normal rounding does not apply to this figure. They are called 'qualifying low emissions cars' in the legislation, QUALECs for short. Diesel adjustments apply to QUALECs as to all others, but that is all; no other reduction which is available on other cars applies to QUALECs. As a result, the only acceptable figures for the appropriate percentage for QUALECs are 13 percent - cars to which the diesel supplement applies, and 10 percent - all other cars. So there is no misunderstanding, electric-only cars are excluded from these arrangements and retain their net appropriate percentage of 9 percent.
- There is a new 2 percent reduction for cars manufactured to be able to run on E85 fuel, a mixture of 85 percent bio-ethanol and 15 percent unleaded petrol. They will be known as type G on forms P46 (car) and P11D. Other cars cannot run on this mixture without damaging the engine.

See also www.hmrc.gov.uk/manuals/eimanual/EIM23400.htm

3.4 Lawful and unlawful dividends

3.4.1 Introduction

As we have seen, it is often tax-efficient for private, family companies to pay dividends as opposed to salary or bonus. Perhaps unsurprisingly, HMRC often request and examine the documentation relating to family company dividends. The issues they often consider include the following:

- Whether dividends are lawful (i.e. whether company law requirements have been satisfied);
- What paperwork is available;

- If lawful, when were the dividends paid; and
- If unlawful, how payments should be treated for tax purposes.

3.4.2 Interim and final dividends

The company's Memorandum and Articles of Association will indicate who is authorised to declare a dividend. Most modern company articles allow directors to declare dividends from time to time (e.g. Companies Regulations 1985, Table A Article 103). Otherwise, dividends are payable only when declared by an ordinary resolution passed by the shareholders in a general meeting. The Articles will often state that the company's directors can declare dividends without the need for a general meeting.

There is a practical distinction between an interim dividend and a final dividend:

Interim dividends are legally due and payable only once actually paid. A resolution to pay an interim dividend can be varied or rescinded, and therefore the resolution does not create a debt until the dividend is paid (Companies Regulations 1985, Table A Article 103) (see *Potel v CIR* (1970) 46 TC 658).

Final dividends should usually be recommended by the directors and approved by the shareholders in ordinary general meeting (Companies Regulations 1985, Table A Article 102). Final dividends are legally due when declared unless a later date for payment is specified, in which case they are due on that payment date.

The dividend payment date can be significant, particularly in small family companies. For example, if the business owners have withdrawn funds 'on account' of dividends being paid, resulting in an overdrawn director's loan account, dividends may be declared to clear the overdrawn loan account. In the case of interim dividends being credited to the loan account, HMRC consider that payment is not made until an entry is made in the company's books. This entry could arise in a later accounting period than the directors' resolution to pay the interim dividend.

3.4.3 Law and unlawful dividends

Lawful dividends

Dividends must comply with company law requirements. For example, the company's Articles should be checked to ascertain who is authorised to declare a dividend. In addition, before declaring an interim dividend, the directors must be satisfied that the company has sufficient profits available for distribution. Profits for these purposes are identified by reference to 'relevant accounts'. These will normally be the company's last annual accounts, except where those accounts show insufficient reserves to legally declare the dividend. 'Interim accounts' may be required in those situations. In the case of

new companies intending to pay an interim dividend in the first accounting period, 'initial accounts' may be appropriate.

Unlawful dividends

For owner-managed businesses in particular, problems often arise when interim dividends are paid during the accounting period. When accounts are subsequently prepared for that period, it may transpire that the company had insufficient distributable reserves to cover the dividend. It is then necessary to consider the tax implications of those payments.

3.4.4 Tax problems with unlawful dividends

In small family companies, HMRC may argue that the director/shareholder knew or had reasonable grounds to believe that the dividend was unlawful. An 'innocent' shareholder in receipt of an unlawful dividend is generally not required to repay it. However, company law requires the shareholder who receives a dividend to repay it, if he has reasonable grounds to believe that it is unlawful (Companies Act 1985, s 277). The time limit for recovery of dividends from the shareholder is generally six years from the date of declaration or its declared payment date, whichever is later (Limitation Act 1980, s 5).

HMRC will probably consider that director/shareholders of private companies ought to be aware (or have reasonable grounds to believe) if a dividend is unlawful. Their guidance on 'ultra vires' dividends (see the *Company Taxation Manual* at paragraph 2007a) indicates that such dividends would be void, and that the director shareholder would normally be treated as holding the funds as constructive trustee for the company. In *Precision Dippings Ltd v Precision Dippings (Marketing) Ltd & Others* [1986] Ch 447, PD paid a £60,000 cash dividend to its parent company PDM, without being aware that the payment contravened company law. Both companies had the same directors. PD later became insolvent, and was liquidated. The company's liquidator sought an order for the dividend to be recovered from PDM. The Court held that the dividend payment was *ultra vires* and consequently recoverable.

The potential tax implications of unlawful dividends in such circumstances include the following:

- Income tax - the dividend is treated as void.
- TA 1988, s 419 (close companies) - The shareholder is deemed to hold the funds as constructive trustee for the company. In most cases, HMRC would argue that the funds therefore represent a loan to a participator, on which the company is liable to a charge of 25% under s 419 (*Company Taxation Manual*, paragraph 2007b).

- Section 419 relief - Relief is available (under TA 1988, s 419(4)) if the dividend is subsequently repaid.
- Distribution - Alternatively, if the shareholder was unaware and had no reasonable grounds to believe that the dividend is unlawful, the dividend will be treated as a distribution, and the shareholder will not be treated as a constructive trustee.

3.4.5 Some pitfalls to avoid

As indicated, the payment of lawful dividends requires some care. For example, if the owners of a new business trading as a private company wish to pay an interim dividend, the requirement that the company must normally have sufficient distributable reserves from which to pay a dividend should be borne in mind (Companies Act 1985, s 263). As no previous annual accounts will be available, 'interim' or 'initial' accounts are 'necessary to enable a reasonable judgement to be made' in determining amounts available for distribution, by reference to profits, losses, assets, liabilities, provisions, and share capital and reserves (Companies Act 1985, s 270(4)). Management accounts may therefore be necessary if dividends are to be paid in the first accounting period, to reduce the possibility of unlawful payments.

Dividends must be properly declared/paid. In many small private companies, there is often some confusion over whether a dividend is interim or final, and when dividends are actually 'paid'. Final dividends are normally treated as paid on the date of the resolution approving the dividend, unless a future payment date is specified. However, in the case of interim dividends being credited to the loan account, HMRC consider that payment is not made until an entry is made in the company's books. The Company Taxation Manual (at paragraph 2007b) states:

'A dividend is not paid and there is no distribution, unless and until the shareholder receives money or the distribution is otherwise unreservedly put at their disposal, perhaps by being credited to a loan account on which the shareholder has the power to draw.'

For inheritance tax purposes, dividends waived within 12 months before entitlement have no IHT effect. However, dividends waived more than 12 months before entitlement constitute a transfer of value. Therefore for dividends in respect of future years, waivers by deed could be made on an annual basis (IHTA 1984, s 15).

3.4.6 It's a Wrap (UK) Ltd

The defendants were directors and shareholders of the claimant company. Notwithstanding that there were no retained realised profits for the years 2001 and 2002, in which the claimant had made trading losses, the defendants caused the company to pay them dividends in respect of those years. The

company was placed into creditors' voluntary liquidation in January 2004. The claimant (acting by its liquidator) brought proceedings for the return of those dividends, relying on s 277(1) of the Companies Act 1985. The judge held that the words 'is so made' in s 277(1) meant 'made in contravention of this Part', and so required the defendants to know or have reasonable grounds to believe not just the facts giving rise to the contravention but also the legal result of that contravention. As he had found that the defendants did not have that knowledge, he held that there was no liability to repay the dividends. The company appealed.

The issue on the appeal was whether, if a company brought a claim against a shareholder under s 277(1), the actual or constructive knowledge that the section required was actual or constructive knowledge of (i) the relevant facts constituting the contravention; or (ii) those facts and in addition the fact that Act had been contravened.

Held - The appeal would be allowed. Section 277(1) had to be interpreted as meaning that the shareholder could not claim that he was not liable to return a distribution because he did not know of the restrictions in the Act on the making of distributions. He would be liable if he knew or ought reasonably to have known of the facts which meant that the distribution contravened the requirements of the Act. Section 277(1) had to be interpreted in conformity with art 16 of Council Directive (EEC) 77/91 (the Second Directive), which it was designed to implement. Article 16 had to be read in the context of the rules on distributions in art 15 of the Second Directive and the general principles of Community law. The provisions of ss 263 to 276 of the Act were designed to implement art 15. On its true interpretation, art 16 meant that a shareholder was liable to return a distribution if he knew or could not have been unaware that it had been paid in circumstances which amounted to a contravention of the restrictions on distributions in the Second Directive, whether or not he knew of those restrictions.

3.5 HMRC guidance on a “new tax” on dividends

3.5.1 Introduction

The long awaited chapter 90000 of the Employment Related Securities Manual (ERSM) is not without controversy which possibly accounts for the delay in its publication. Anti-avoidance clauses added post-ITEPA 2003 have helped to create an extremely broad piece of legislation, something which has been pointed out to HMRC by all the leading tax bodies, and caused no end of speculation throughout the last two years.

S 447 in chapter 4, creates a tax charge on what are termed "post acquisition benefits" deriving from employment-related securities (which includes shares). It applies to UK resident and ordinarily resident employees, and is a mopping up clause, to tax any benefits which have not been caught elsewhere in Chapters 2 to 3d of ITEPA, or otherwise taxed as employment income for the employee or another associated person.

The tax charge may apply to any benefit received after 16 April 2003, regardless of when the securities were received, but only applies to securities which are employment-related, so those which have been acquired through a personal relationship, such as gifted to friends and family are unaffected.

The most common benefits that HMRC have in mind here are dividends, if paid as employment reward or if the anti-avoidance clause is breached. However, benefits can include a whole range of things, from free ferry journeys to vouchers to bonus shares. Non-employee investors should not be affected.

3.5.2 The anti-avoidance clause

A benefit may only come into charge if it is not taxed elsewhere or where something has been done which affects the employment-related securities as part of a scheme or arrangement, the main purpose (or one of the main purposes) of which is the avoidance of tax or National Insurance contributions.

The new chapter is at pains to point out that this does not mean a wholesale attack on all small companies who chose to pay dividends as their chosen method of profit extraction.

It says:

“Where an owner-managed company, run as a genuine business, pays dividends out of company profits and there is no contrived scheme to avoid income tax or NIC on remuneration or to avoid the IR35 rules, HMRC will not seek to argue that a Chapter 4 benefit has been received by the directors because... (it has been taxed elsewhere as a dividend).”

3.5.3 Dividends and tax-avoidance

ERSM90210 says that if dividends are paid on the shares of a special purpose vehicle (SPV) companies (where the “special” purpose is that they are set up to pay employees bonuses) then they may be caught by the extra tax charge (this may be a very good time to stop calling any companies SPVs, as some in the Revenue may henceforth be starting to assume that something is a SPV primarily for tax avoidance purposes).

3.5.4 The tax charge

HMRC seem quite cautious in discussing the actual tax charge, there are many “mays” and “coulds” within the guidance. It is quite likely that we will only see how the charge will work when we unravel the full details of some of the schemes that HMRC are trying to target when and if these reach the courts. There are the transitional and retrospective rules to consider and also the NIC position, which is complicated by the National Insurance Contributions Act 2006.

Dawn Primarilo confirmed some time ago that the FA 2005 changes to “post-acquisition benefits from securities” are not aimed at the low salary/high dividend practice of small owner managed businesses (Standing Committee B 21 June 2005). We await with bated breath as to whether HMRC remain true to these words!

At the CIOT Tax Update Conference at Homerton College , Cambridge in April 2007 Andrew Thornhill QC explained that a company validly declaring and paying dividends to directors/employees on ordinary shares carrying full rights should not be caught under s.447 ITEPA 2003. The points made above on ensuring that dividends meet the requirements of the Companies Act cannot be reinforced enough.

3.6 Rental income

Rental payments can prove advantageous as the company may deduct the rents in arriving at its corporation tax profit, provided that such rents do not exceed a commercial arm’s length amount. It is advisable to put in place a formal rental agreement and have independent rental valuations carried out by a suitably qualified expert on a regular basis. Failure to instigate this may lead to an Inland Revenue challenge on the deductibility of the rents.

In many situations these days directors of smaller companies establish their business premises in their home. It is still possible to extract profit by way of rental income by the individual renting the business facilities to the company. Again, a robust rental (or licence) agreement should be in place. In order to prevent the loss of Principal Private Residence relief on the ultimate disposal of the home it is advisable to state in the agreement that the facilities are only let to the company for designated hours each week, for example, 9.0am to 5.0pm Monday to Friday. The operation of the taper relief rules significantly restricts the relief available where part of a home is used exclusively for business purposes.

3.7 Loan interest

It is possible to extract profit from a family company by paying interest on the director/shareholders’ current and/or loan accounts. In order to satisfy the Finance Act 1996 Loan Relationships rules it is important that the interest rate used reflects a commercial payment by the company. Creating a simple loan agreement or board minute stating that interest on loan or current accounts will be paid by the company at a rate of 2% above base rates often satisfies this test. A higher interest rate may be used provided the risk profile of the company justifies this.

In order to obtain a corporation tax deduction for any interest payments it is important to ensure actual payment is made within twelve months of the end

of the accounting period. Accrued interest payments made after this date will only obtain tax relief in the accounting period of payment.

Creation of a loan account

Following the abolition of Stamp Duty on goodwill transfers from 23 April 2002 it has been tempting in recent incorporations to establish significant loan accounts by assigning a significant value to the goodwill. It is essential that the valuation of the goodwill can be justified using the normal principles of third party, full information price.

3.8 The interaction with pension contributions

3.8.1 Introduction

Under the pension rules that came in on 6 April 2006 a company may contribute up to £235,000 (2008/09) into a SIPP or other qualifying scheme without any reference to an individual's earnings. A taxpayer drawing a salary in the region of £5,000 and topping it up with dividends could have £235,000 contributed to the SIPP by his company post 5 April 2008. The limit was £215,000 for 2006/07 and £225,000 for 2007/08.

Consequently, an owner managed company with strong cash reserves has an attractive option under the new rules. If the owner is keen to invest in his/her pension their company could contribute up to the upper limit into their SIPP (assuming no other contributions made). Full tax relief should be available to the company on the SIPP contribution subject to the wholly and exclusively rules. The SIPP could then invest in property for the benefit of the owner manager.

Alternatively, if the individual is over the age of 50 they could draw an immediate 25% tax free lump sum from the SIPP, leaving the SIPP to invest the remainder. This would be attractive to some owner managed businesses holding large cash reserves within their company.

This would be a tax efficient way of extracting funds and improving the taper position of the shares in the company.

We must however be very wary of the Revenue's interpretation of the wholly and exclusively" rules that now govern the deductibility of pension contributions by employers.

3.8.2 Key points of HMRC guidance on "wholly and exclusively"

The points below were published by HMRC in January 2006:

- Deductions are allowed for contributions made wholly and exclusively for the purposes of the employer's trade

- All contributions are treated as revenue expenditure, not capital expenditure
- Deductions for an employer's contributions are allowed for the period of account in which they are paid by the employer and for no other period, unless the deduction is required to be spread over a number of periods,
- In other words, the accounting treatment is not followed for tax purposes. The deduction in the Profit & Loss account should be added back in the tax computations and replaced by a deduction for contributions paid during the period of account.
- Spreading of deductions may be required under s197 FA 2004 where there is an increase over 210% in the level of employer contribution from one period to the next.
- Where contributions to a group pension scheme are made by the holding company in the group with each employing subsidiary company in the group being recharged an appropriate amount relating to its employees, the intra-group recharge may be accepted as being a contribution paid by the employer to the registered scheme.
- Such recharges should be accepted as contributions paid by the employer in the period of account in which the holding company paid the contribution to the registered scheme.

3.8.3 Further guidance published in June 2007

This further guidance governs how and when employers receive tax relief on contributions to registered pension schemes. The clarification particularly affects owners and controlling directors of companies.

As part of the A-day changes, HMRC deemed that any employer pension contribution would only receive corporation tax relief if it were 'wholly and exclusively' for the purposes of the business. The original guidance confirmed that the vast majority of pension contributions will receive full tax relief.

The further clarification concerns payments on behalf of controlling directors and connected people. It confirms that if a controlling director or owner takes a remuneration package up to the level of company profits, this should be acceptable as the profit reflects the value added by that individual. That remuneration package can be any combination of pension or salary.

This new guidance can be found in HMRC's *Business Income Manual*, paras 47105 and 47106

Andrew Tully of Standard Life Assurance Ltd says that the 'clarification is good news for owners of companies and their advisers'. He says that HMRC have confirmed that in the case of controlling directors and owners, 'it is very likely that tax relief will be given'. Furthermore, 'for connected people such as spouses, pensions contributions comparable with unconnected employees is acceptable'. Mr Tully says that 'if there is no comparable employee, a contribution which aims to provide a reasonable benefit at retirement, e.g. a

benefit equivalent to two-thirds of salary, should not give HMRC any cause for concern’.

www.hmrc.gov.uk/manuals/bimmanual/BIM47106.htm

3.9 Profit retention

Where the owners of a family company do not require all the funds from the company at the present time it may be worth considering rolling them up and extracting the funds by way of a capital gain on future disposal of the shares (either on sale or on winding-up of the company).

This route is worthy of consideration provided the shares are eligible for entrepreneurs relief, as this reduces the effective rate of tax (at the higher rate) to just 10% where the gains are under £1m.

The Revenue previously stated in Tax Bulletin articles published in June 2001 (issue 53) and December 2002 (issue 61) that shares in an unquoted trading company will not qualify as business assets where more than 20% of the company’s activities are other than trading. This was originally aimed at the now extinct business asset taper rules but HMRC have confirmed that they will use this definition for ascertaining the availability of the new entrepreneurs relief when disposing of shares.

The 20% test varies according to the facts of each case. Aspects to consider are:

- ◆ turnover from non-trading activities
- ◆ asset base of the company
- ◆ expenses incurred in undertaking the company’s activities
- ◆ time spent in undertaking the company’s activities
- ◆ historical context of the company

The asset base of the company is likely to increase where profit is not extracted from the company prior to disposal of shares. Cash balances (or other short-term investments) will need to be justified as being held for future purposes of the trade. Any “unjustified” balances that exceed 20% of the company’s activities may jeopardise the availability of taper relief in future years.

4. The New Capital Allowances Regime

References are to CAA 2001 unless otherwise stated.

4.1 The “Annual Investment Allowance” (AIA)

S.38A

For accounting periods ended on or after 6 April 2008 (1 April 2008 for companies), a new “annual investment allowance” (AIA) has been introduced. The AIA is intended to “encourage greater levels of investment by reducing the costs of capital”.

The new “annual investment allowance” gives a 100% first year allowance for the first £50,000 of investment in “standard” plant & machinery (excluding cars but including integral features – see section 2). The AIA replaces the existing first year allowances available to small and medium businesses.

The AIA is available to all businesses (including ordinary property businesses and large companies), although only one £50,000 annual allowance will be available to each business each year.

A group of companies is treated as one business for the AIA, although “associated” companies will get one AIA each.

Sole trader businesses and partnerships will each receive an AIA. Therefore where an individual is involved in more than one business (for example, he may be a partner in a firm and run a sole trader business in his own right at the same time), both businesses will receive an AIA.

However where an individual has more than one trade, he is only entitled to one AIA between the trades. He may then allocate the AIA across the trades as he sees fit.

If the accounting period of the businesses is more or less than 12 months long, the AIA is proportionately reduced or increased. Thus for a business drawing up a 9-month set of accounts, the AIA limit will be $£50,000 \times 9/12 = £37,500$.

Expenditure in excess of the AIA limit in the year will be dealt with under the standard rules for capital allowances, qualifying for capital allowances at either 10%, 20% or the “hybrid rates”.

Unused expenditure will be lost – there is no provision for the unutilised portion of the £50,000 allowance to be carried forward.

Where the accounting period spans 6 April 2008:

- 1) pre April 2008 expenditure will qualify for first year allowances under the “old” rules at either 50% or 40%; and
- 2) post April 2008 expenditure will qualify for CAs under the new AIA rules. The £50,000 threshold will be restricted for the number of months in the accounting period which fall after April 2008.

4.1.1 Illustration 1

Craig is a self-employed car mechanic. He draws accounts to 30 September. In the year ended 30 September 2008, Craig incurred the following capital expenditure;

		Cost £
1 December 2007	Pressure washer	10,000
1 July 2008	Hydraulic car lift	40,000

His general pool brought forward at 1 October 2007 was £12,000.

We will calculate Craig’s capital allowances for the year ended 30 September 2008.

Solution

- Expenditure before 6 April 2008 qualifies for FYAs at 50%.
- Expenditure on or after 6 April 2008 qualifies for FYAs at 100% up to the AIA.
- The AIA for the year ended 30 September 2008 is
 $£50,000 \times 6/12 = £25,000$.

The hybrid CA rate for expenditure in the general pool is;

6 months at 25%	$6/12 \times 25\%$	12.5%
6 months at 20%	$6/12 \times 20\%$	<u>10.0%</u>
Hybrid rate in transitional period		<u>22.5%</u>

The capital allowances computation will therefore be:

Y/e 30.9.08:	FYAs @ 50% £	FYAs @ 100% £	General Pool £	Total £
B/fwd			12,000	
Additions:				
Pressure washer	10,000			
Hydraulic car lift		<u>25,000</u>	<u>15,000</u>	
	<u>10,000</u>	<u>25,000</u>	<u>27,000</u>	
FYA @ 50%	(5,000)			5,000
FYA @ 100%		(25,000)		25,000
WDA @ 22.5%			<u>(6,075)</u>	<u>6,075</u>
			20,925	
Transfer to pool	(5,000)	NIL	<u>5,000</u>	
C/fwd at 30.9.08			<u>25,925</u>	
CA claim for year				<u>£36,075</u>

The AIA rules replace the “old” rules for first year allowances. However 100% FYAs for environmentally beneficial technologies (energy or water saving plant), Flat Conversion Allowances, Business Premises Renovation etc, will continue as before and will be unaffected by the new AIA.

4.2 Integral features

S.33A

For capital allowances purposes the boundary between what is a “plant and machinery” and what is a “commercial building” is not absolutely clear.

Instead, case law draws a distinction between equipment “with which” a business is carried on and the premises or setting “in which” the business is carried on. These case law tests were (to a certain extent) consolidated and given statutory authority in Capital Allowances Act 2001.

This has essentially meant that certain assets which are “integral” to a building (such as air conditioning systems and lifts etc) previously qualified for 25% writing down allowances whereas others (such as electrical and water systems) were deemed to be part of the building and did not qualify for CAs.

From 6 April 2008, “integral features” are separately identified in a new “special rate pool” on which writing down allowances will be given at 10%. According to the government, assets such as lifts and air-conditioning systems have a longer economic life than other more “productive equipment” used in the business, so the new special rate pool offers “a more appropriate rate of write-off of these assets”.

A separate pool need only be kept for integral features acquired on or after 6 April 2008. Such assets bought before April 2008 will either qualify for FYAs (or, for large enterprises, go into the general pool). Some may not have qualified for any capital allowances at all.

Where such “integral features” are bought second-hand after April 2008, they may have received a 40% or 50% FYA for the initial user - now they will receive a 10% WDA for the new user.

Expenditure on integral features on or after 6 April 2008 will always qualify for writing down allowances at 10% (irrespective of whether this falls into a transitional period).

FA 2008 introduced a list of features which are “integral” to a building and which will therefore only qualify for capital allowances at 10%. These are;

- Lifts, escalators & moving walkways
- Space & water heating systems
- Air-conditioning and air cooling systems
- Hot & cold water systems (excluding toilet & kitchen facilities)
- Electric lighting and power systems
- External solar shading

From April 2008 expenditure on thermal insulation in buildings will also be allocated to the “special rate” pool and will be given allowances at 10%.

S.28

4.2.1 Illustration 2

Jamie runs a business making aquariums and garden fish-ponds from a small factory in Colchester. He started trading on 1 January 2008. In his first year of trading to 31 December 2008, Jamie incurred the following capital expenditure;

	Cost £
1.1.08 Factory	300,000
1.1.08 New electrical wiring system for factory	25,000
1.1.08 Machinery	50,000
1.5.08 Energy efficient motors	40,000
1.6.08 2 delivery vans	30,000
1.6.08 Air-conditioning units for factory	12,000
1.7.08 New roof on staff canteen	25,000
1.12.08 Computer equipment	16,000

We will calculate Jamie’s capital allowances for the year ended 31 December 2008.

Solution

- Expenditure on the factory does not qualify.
- Expenditure before April 2008 on general wiring does not qualify (S.21 CAA 2001, List A).

- Expenditure on plant and machinery before 6 April 2008 qualifies for FYAs at 50%.
- Expenditure on energy saving plant and machinery qualifies for FYAs at 100% (unaffected by the AIA).
- Expenditure on plant and machinery on or after 6 April 2008 qualifies for FYAs at 100% up to the AIA.
- The AIA for the year ended 31 December 2008 is
 $£50,000 \times 9/12 = £37,500$.
- Expenditure on integral features on or after 6 April 2008 qualifies for WDAs at 10%.
- As we can choose what we allocate the AIA to, we will first allocate it to the integral features.
- The new roof is not an integral feature – it is part of a building and does not qualify.

The hybrid CA rate for expenditure in the general pool is;

3 months at 25%	$3/12 \times 25\%$	6.25%
9 months at 20%	$9/12 \times 20\%$	<u>15.0%</u>
Hybrid rate in transitional period		<u>21.25%</u>

The capital allowances computation will therefore be:

	FYAs @ 50% £	FYAs @ 100% £	General Pool £	“10%” pool £	Total £
Additions:					
Machinery	50,000				
Motors		40,000			
Air-conditioning		12,000			
Delivery vans		25,500	4,500		
Computers			<u>16,000</u>		
	<u>50,000</u>	<u>77,500</u>	<u>20,500</u>		
FYA @ 50%	(25,000)				25,000
FYA @ 100%		(77,500)			77,500
WDA @ 21.25%			(4,356)		4,356
Transfer to pool C/fwd @ 31.12.08	(25,000)		<u>25,000</u> <u>41,144</u>		
CA claim for year					<u>106,856</u>

Note:

None of the expenditure is allocated to the “10% pool” as the expenditure on integral features in the period (£12,000) is less than the AIA (£37,500).

4.2.2 Repairs to integral features

The Finance Act of 2008 introduces new rules for determining what is a repair and what is a replacement of an integral feature. These rules will not apply to the repair of non-integral features.

The rules state that expenditure incurred by a person on an integral feature is expenditure on the replacement of the asset in two scenarios:

- the expenditure is more than 50% of the cost of replacing the integral feature at the time the expenditure is incurred; or
- the initial expenditure is not more than 50% of the cost of replacing the integral feature at the time the expenditure is incurred, but within the 12-month period starting with the initial expenditure further expenditure is incurred, the aggregate of the amounts being more than 50% of the cost of replacing the integral feature.

These rules will, with regard to integral features, override any other rules in tax law or accounting practice on what is capital or revenue expenditure. In addition, it would appear that the Finance Bill does not limit this rule to expenditure on assets that were originally acquired after April 2008, but applies to all expenditure on assets that are on the list in s 33A. This would mean that all expenditure on 'repairs' of items on the integral features list needs to be considered in light of these new rules, regardless of when the original asset was acquired. Given that no allowances would have been available in an office building for, say, general lighting, it does seem unfair that the repair of the lighting may well be caught by the provisions of s 33B.

The compliance burden in this area could be significant. Apart from anything else, at the outset of any project involving repairs to a building the taxpayer will need to calculate an estimated replacement cost for any integral feature that will be affected by the works. This calculation will be an additional one purely required for tax purposes. And it may not be a straightforward one. The integral features list refers to systems, with no guidance being provided as to where a system begins and ends. So, for example, if a company has three floors as a tenant in a multi-storey building and decides to repair/replace the electrical wiring and some of the lighting to only one of their floors, does this company assess 'the system' on that floor back to the local distribution board, or the cost for all three floors? You would hope it is the latter but it is unclear.

4.2.3 Transfers between unconnected parties

There are several items on the integral features list that would not have generally attracted allowances under the old regime; for example, in an office building, general electrical and lighting systems and cold water systems. If a taxpayer acquires the qualifying interest in land from an unconnected party, it has acquired the fixed plant and machinery (fixtures) in that building, including integral features. As these items will be included within the sale of the building, the buyer will be incurring expenditure on the provision of an integral feature of a building and will therefore be able to claim allowances on these items on a just and reasonable apportionment of

the sale price. The buyer will not be restricted by a prior claimant's restriction on these assets, because these assets are likely to have been non-qualifying expenditure in all prior owners' hands and therefore the expenditure could never have been included in any general pool. Hence, in respect of these assets, the CAA, s 185 restriction will not apply and a CAA, s 198 election cannot be entered into.

4.2.4 Transfers between connected parties

The availability of allowances on integral features, that were non-qualifying expenditure under the old regime, in respect of property sales will not be available for sales between connected parties (as defined in CAA, s 575). Finance Act 2008 introduces a provision at para 15 of Sch 26 that provides that if the buyer and seller are connected persons, any expenditure by the buyer on integral features that were not qualifying assets at the time the seller acquired them will not be qualifying expenditure for the buyer. The paragraph is also drafted so as to catch chains of sales between connected parties.

4.2.5 Intra-group transfers of previously qualifying integral features

When transferring property, including integral features, items that previously sat in the general pool but are now integral features (such as heating systems and lifts) will attract allowances at a lower rate for the buyer than they would for the seller. Therefore, para 16 of Sch 26 includes provisions to allow for a buyer and seller within the same chargeable gains group to jointly elect that a transfer of such an item will be at a price which gives rise to neither a balancing charge nor a balancing allowance for the seller, and the buyer's expenditure will not be special rate expenditure but will be allocated to the buyer's general pool (therefore attracting allowances at the faster rate).

4.2.6 Splitting assets between the two pools

The reality here is that dealing with integral features on the transfer of existing buildings will not be a simple process. Ownership of property assets pre and post April 2008 will require consideration of two sets of complicated rules. If it is then decided to sell the property interest, disposal values, elections and entitlements will need to be determined under two different codes.

4.3 Small plant & machinery pools

S.56A

From 6 April 2008, businesses can claim a writing down allowance of up to £1,000 when the tax written down value brought forward in either the general pool or the new “special rate pool” (“10% pool”) is £1,000 or less.

This means that businesses who have very small brought forward balances in the general pool will no longer have to calculate WDAs at 20% on such pools – instead where the pool is £1,000 or less, the full amount can be written

down. This is intended to lessen the administration burden for small businesses.

Businesses do not have to take the maximum allowance – they may claim less than the whole residue if they prefer.

This rule applies for accounting periods beginning on or after 6 April 2008 (1 April 2008 for companies).

The small pool limit £1,000 is scaled up or down for short or long accounting periods. It does not apply to “single asset” pools.

4.3.1 Illustration 3

Nancy is a full-time mother, but for 2 evenings a week she runs a fitness class at the local community centre. Her only capital assets are some fitness equipment and a computer bought a couple of years ago for £2,400. She draws accounts annually to 30 June. The written down value of the general pool at 1 July 2007 is £900.

Her capital allowances computations are as follows:

The hybrid CA rate to be applied for the year ended 30 June 2008 will be;

9 months at 25%	$9/12 \times 25\%$	18.75%
3 months at 20%	$3/12 \times 20\%$	<u>5.00%</u>
Hybrid rate in transitional period		<u>23.75%</u>

Year ended 30 June 2008:	Pool	CA claim
	£	
Tax written down value b/fwd at 1.7.07	900	
WDA @ 23.75%	<u>(214)</u>	<u>214</u>
Tax written down value c/fwd at 30.6.08	<u>686</u>	
 Year ended 30 June 2009:		
Tax written down value b/fwd at 1.7.08	686	
WDA	<u>(686)</u>	<u>686</u>
Tax written down value c/fwd at 30.6.09	<u>NIL</u>	

4.4 Long life assets – FA 2008 changes

s. 91

Before April 2008, long life asset expenditure qualified for writing down allowances at 6% on a reducing balance basis.

From April 2008, writing down allowances on long life assets have increased to 10%. The new 10% rate applies to

- i. long life assets bought after April 2008; and
- ii. to the tax written down value brought forward on “old” long life assets acquired before April 2008.

As for standard plant and machinery allowances, where the accounting period straddles 6 April 2008, a “hybrid” CA rate will be calculated.

4.4.1 Illustration 4

Wombat Ltd is a large company with a year-end of 31 July.

In May 2006, Wombat Ltd bought a large production line for £500,000. The production line has an estimated useful life of 30 years. It is therefore classed as a long-life asset for capital allowances purposes.

The CAs claimed to date have therefore been as follows:

	£
Y/e 31.7.06:	
Addition (May 2006)	500,000
Less; WDA @ 6%	<u>(30,000)</u>
C/fwd at 31.7.06	<u>470,000</u>

B/fwd	<u>470,000</u>
Less; WDA @ 6%	<u>(28,200)</u>
C/fwd at 31.7.07	<u>441,800</u>

The hybrid CA rate to be applied for the year ended 31 July 2008 will be;

8 months at 6%	8/12 x 6%	4.000%	
4 months at 10%	4/12 x 10%	<u>3.333%</u>	
Hybrid rate in transitional period		<u>7.333%</u>	<u>7.34%</u>

The CAs for the year ended 31 July 2008 will be;

	£
B/fwd at 1.8.07	441,800
Less; WDA @ 7.34%	<u>(32,428)</u>
C/fwd at 31.7.08	<u>409,372</u>

For expenditure on long life assets on or after 6 April 2008 (1 April 2008 for companies), writing down allowances will be given at 10%, irrespective of whether this falls into a transitional period.

4.5 The “special rate pool”

Expenditure to be allocated to the new “special rate pool” will fall into two categories:

- 1) Pre-existing “long life asset” expenditure; &
- 2) Expenditure incurred after 6 April 2008 on “long life assets” and on “integral features”.

4.5.1 Illustration 5

Wombat Ltd (Illustration 4 above), bought a long life asset in May 2006 for £500,000. Capital allowances for the year ended 31 July 2008 are as follows:

	£
B/fwd at 1.8.07	441,800
Less; WDA @ 7.34% (“hybrid rate”)	<u>(32,428)</u>
C/fwd at 31.7.08	<u>409,372</u>

On 1 May 2008, Wombat Ltd incurred expenditure of £100,000 on a new escalator in its head office. This is classed as expenditure on “integral features” and will therefore be allocated to the special rate pool. As it is expenditure after 1 April 2008, the expense will receive CAs at 10% in the year ended 31 July 2008 (there is no need to calculate a “hybrid” rate):

Y/e 31.7.08:	10% pool
Additions:	£
Escalator 1.5.08	100,000
Less; WDA @ 10%	<u>(10,000)</u>
	90,000
Add; balance of expenditure on pre 2008 long life assets (above)	<u>409,372</u>
“10% pool” c/fwd at 31.7.08	<u>499,372</u>

Thereafter, all WDAs in this pool will be at 10%.

4.6 Payable enhanced capital allowances

Tax credits are available on expenditure incurred on or after 1 April 2008.

A company will be able to surrender the portion of a loss from a qualifying activity that is attributable to qualifying payable ECA expenditure. For example, a company buys qualifying plant and machinery (after 1 April 2008) costing £200,000 for use in its trade and claims a 100% first year allowance (FYA) or ECA of 200,000. It makes a loss (as calculated for tax purposes) of £300,000 (after deduction of the ECA). The loss that the company may surrender for a tax credit is £200,000, being the portion of the loss that relates to the ECA expenditure.

The loss that may be surrendered is the (relevant portion of the) loss, calculated for tax purposes, made in the chargeable period. It will not include any losses brought forward from a previous accounting period or carried back from a subsequent period.

A company will be able to surrender all or only part of its available ECA loss for a tax credit as it chooses. Any balance of loss not surrendered may be claimed under any of the available existing loss relief provisions. A company will not be able to surrender a loss for an ECA tax credit if that loss could either be used to off-set other taxable profits of that company or surrendered as group relief in the same accounting period.

The amount payable to a company claiming payable ECAs will be expressed as a percentage of the loss that is surrendered. The percentage is 19% for all companies. So if a company surrenders a loss of £100,000, the payable ECA it will receive is £19,000.

The rate at which ECA tax credits are paid is linked to the small companies rate of corporation tax, which will be 21% from April 2008. The Government considers that the proposed payment rate will be attractive to companies that are loss making, particularly in start-up situations where the losses may not be utilised for two or more years.

There will be an upper limit, or “cap” on the amount of payable ECA which maybe claimed by a company.

The cap will be set at the level of the company’s PAYE and national insurance contribution liabilities for payment periods ending in the chargeable period for which the claim has been made

To deal with the problem of companies with small PAYE bills it is proposed that the upper limit of payable ECA should be the greater of (a) the total amount of the company’s PAYE and NIC liabilities for payment periods ending in the chargeable period and (b) £250,000. For clarity, the £250,000 is the amount of the tax credit that can be claimed rather than the quantum of the loss that can be surrendered. This means that a company can surrender a loss of up to £1,315,789 regardless of the amount of its PAYE and NICs liabilities.

A company must make a claim for an ECA tax credit in a return or an amended return. The amount of the claim or the amended claim must be specified in the return.

Where a company has outstanding liabilities to corporation tax then HMRC will use the ECA payment claimed to set against and reduce those liabilities. Where the ECA payment has been set against any amounts owed by the company then, obviously, it will no longer be available to be paid to the company. If the ECA payment due is greater than the outstanding liabilities, then the excess will be paid to the company.

Similarly, HMRC will not make a payment in respect of payable ECAs where a company has not paid the full amount that it is required to pay under the PAYE regulations or in respect of Class 1 national insurance contributions.

ECA payments will be recouped or clawed back where relevant equipment (that is, equipment which has qualified for a payable ECA) is sold or otherwise disposed of. The rules for deciding whether plant or machinery has been disposed of for ECA purposes are the same as for capital allowances.

HMRC will only seek to claw back ECA payments where the disposal occurs within the period that begins on the date the expenditure on the relevant plant and machinery is incurred and ends 4 years after the end of the chargeable period for which the tax credit was paid.

However, the Government recognises that there may be a genuine commercial reason for the company making the disposal, and, to take this into account, the company will be able to retain its ECA payment to the extent that it has made a loss on the disposal. This way the company will still have received the benefit of payable ECAs on its net cost of investing in “green” plant and machinery.

4.6.1 Example

A company spends £5m on combined heat and power plant and machinery, which Defra certified as qualifying for ECAs, on 31 March 2009. As it made a loss for tax of £10m in the year to 31 December 2009 it surrendered £5m of its loss and received an ECA payment of £950,000 (£5m @ 19%). On 30 December 2011 it sells the CHP equipment to another company for £4m. We would look to recoup £760,000, being £4m @ 19%. The net result is that the company receives a payment (£190,000 = £1m @ 19%) in respect of the amount it invested (for the requisite period) in environmentally friendly technology.

When payable ECAs are clawed back the losses that the company surrendered will be restored, so that it is put back to the position that it would have been in if the losses had not been surrendered, or a lesser amount of losses had been surrendered.

In the above example the company would originally have had losses of £5m available at 31 December 2009 to carry forward against profits of a subsequent period (£10m less £5m surrendered for an ECA payment). When the equipment is sold and the payment in respect of £4m recouped, the losses carried forward at 31 December 2009 should be increased to £9m, reflecting the fact that the company only ultimately got a payment in respect of £1m of its losses.

The ECA payments will be clawed back as required by means of a special assessment.

5. Planning for Disposal of the Family Business

5.1 CGT from 2008/09

5.1.1 General proposals

The Finance Act of 2008 reformed and simplified the CGT regime with effect from 6 April 2008. The key changes are:

- The withdrawal of taper relief for all assets
- The introduction of a flat rate of CGT of 10% for certain business asset disposals (after entrepreneurs' relief) and a flat rate of 18% for all other disposals
- There are no special reliefs for holding assets for the longer term
- The withdrawal of existing entitlement to indexation allowance where the asset was held before 6 April 1998
- An automatic rebasing of assets held on 31 March 1982 to their market value on that date (with 'halving relief' abolished).

Other reliefs such as annual exemption, loss relief, gift hold-over relief for business assets, roll-over relief for business assets and EIS reliefs continue.

5.1.2 Entrepreneurs' relief

Until 24 January 2008, and the announcement of entrepreneurs' relief, the main losers from the proposed reform were going to be taxpayers who wished to dispose of business assets and have, for many years now, anticipated a gain taxed at no more than 10%. Those particularly disadvantaged by the originally proposals are taxpayers who may hold assets with entitlement to indexation allowance. Hardest hit therefore are shareholders in family companies reaching retirement. Only where a business asset has been held for less than two years would the effective rate of CGT been higher now than under the new CGT rate of 18%.

The new entrepreneurs' relief is intended to meet the concerns of those taxpayers who were perceived to be unfairly targeted by the original reforms. It works by allowing the first £1 million of gains made in a taxpayer's lifetime to be charged to CGT at an effective rate of 10% (being 5/9ths of the 18% rate) where the gain is made on:

- the disposal of all or part of a trading business or shares in a trading business, or
- the disposal of assets following cessation of a business.

When the lifetime threshold of £1 million is breached, further gains will be subject to CGT at the normal flat rate of 18%.

Example

Sarah sells her trading business and realises gains of £450,000 (before entrepreneurs' relief)

Gain	450,000
Less relief (4/9 of £450,000)	<u>(200,000)</u>
Chargeable gain (before annual exemption)	<u>£250,000</u>

Conditions for the new relief are based broadly on retirement relief which was eventually phased out in 2003 with the promise that the new rules will be 'simpler'.

The main winners appear to be higher rate taxpayers disposing of non-business assets. In the context of these notes, an individual selling a company that fails to meet the test of trading (either unintentionally or because it had always intended to carry on an investment business) would currently have an effective rate of 24% assuming 10 year taper relief. Disposing after 6 April 2008 and taxed at 18% would clearly be the better option.

Other details:

- Gains on the disposal of assets formerly used in a business that has ceased, and not disposed of as a going concern, will qualify for relief if disposed of within three years of cessation.
- An individual disposing of shares will qualify for relief if:
 - He has been an officer or employee of the company, or of a company in the same group of companies, and
 - Owns at least 5% of the ordinary share capital of the company and that holding enables the individual to exercise at least 5% of the voting rights in that company.
- The terms 'trading company', holding company' and 'trading group' have the same meaning as they used to do for the purposes of taper relief on business assets. These rules are summarised below.

5.1.3 Meaning of 'trading company' and 'trading group'

The legislation defines a "trading company" as a company carrying on "trading activities" whose activities do not to any substantial extent include activities that are not trading activities. This is common to both the substantial shareholdings exemption and CGT business asset taper.

HMRC originally set out their interpretation, on the meaning of "trading company" and certain other statutory terms for the purposes of both taper relief and the substantial shareholdings exemption, in Tax Bulletins 53 and 62.

TB 53 (June 2001) included an article which explained the Inland Revenue's approach to interpreting the meaning of trading company and holding company of a trading group for the purposes of taper relief.

However, paragraphs 9 and 10 of Schedule 10 to Finance Act 2002 revised the definitions of trading company and trading group for taper relief purposes for periods of ownership from 17 April 2002. The definition of holding company was also revised. Further, the qualifications for investment in a joint venture company as they affect the question as to whether a company or group was a trading company or trading group during a period were relaxed.

The definitions described in TB 53 therefore now apply only for periods of ownership before 17 April 2002 even where the disposal takes place on or after that date.

The Revenue's interpretation following the changes made in Finance Act 2002 and the introduction of SSE (which employs similar terms) were published in TB 62. This has since been superseded as a result of incorporating the guidance in the Capital Gains Manual at CG 17953i to CG 17953r (for taper relief) and at CG 53113 to CG 53120 (for SSE). Both are almost identical in their wording.

5.1.4 Associated disposals

An employee or officer qualifying for entrepreneurs' relief will also be eligible for relief on any 'associated disposal' of an asset which was used in the company's or group's business. For example, if a director owns the building in which the company operates and sells it at the same time as his shares in that company, that sale may count as an associated disposal attracting entrepreneurs' relief. A similar rule operates for 'associated disposals' by a member of a partnership.

5.1.5 Trustees

Trustees will benefit from the relief on gains on assets used in a business where the beneficiary of the trust is involved in carrying on the business in question, personally or as a partner. Where the trust's assets are shares, the beneficiary must be an employee or officer of the company.

5.2 Pre-sale dividends

Classic planning prior to the sale of a company before the introduction of business asset taper relief was to reduce the value of the target company and hence the capital gain on sale by the payment of a pre-sale dividend to the shareholders. This had the effect of swapping a capital gain taxed at 40% with an income distribution taxed at effectively 25%.

The gradual introduction of business asset taper has had the effect of making this form of planning redundant. Now that business asset taper reduces chargeable gains to 25% for disposals on or after 6 April 2002 where the shares have been held for at least 2 years the effective capital gains tax rate is

10% for a higher rate taxpayer. Clearly such planning is no longer effective where full business asset taper is in point.

In a private company sale the shareholder/directors may consider paying themselves an ex-gratia payment to take advantage of the £30,000 tax free amount potentially available. The Revenue are likely to take the view that this represents additional consideration for the sale of the business and treat the sum as additional proceeds and there is case law to support the Revenue view.

A better alternative would be to make special pension fund contributions on the directors' behalf as such payments would also attract a corporation tax deduction.

5.3 The form of consideration

Receiving cash for shares should have straight forward CGT consequences, with a CGT computation being prepared in the normal way.

An important factor may be determining the date of the sale. This will normally be the date of exchange of contracts unless the contract is conditional whereupon the disposal date will be the date on which that condition (which must be a condition precedent) is satisfied. Determining the date of sale would affect the calculation of taper relief (none after 5 April 2008); and the tax year in which the disposal takes place. Conditional contracts can be used to defer the disposal point past 5 April into a new tax year and therefore postpone the CGT by twelve months.

Apart from cash, there are a number of common ways in which a share sale will be structured, often dependent on the form of consideration that the vendor wishes to receive.

These notes consider

- Paper for paper exchanges
- Acquisition for loan loans
- Acquisitions involving deferred consideration and earn outs

5.4 Paper for paper exchanges

The capital gains legislation provides an important and automatic relief where there is an exchange of securities in one company for those in another company in a typical takeover situation. s.135(2) TCGA 1992

No chargeable disposal arises and instead the new securities issues (shares or debentures) are treated as ‘standing in the shoes’ of the old shares and take on the same base cost and deemed to have been acquired when the old shares were acquired.

However, where the new shares are sold after 5 April 2008 the chargeable gain will be taxed under the new CGT regime and therefore any taper relief accrued on the old shares (and new shares) falls away, although any indexation allowance to April 1998 will be retained.

Such a “paper for paper” transaction does not amount to a chargeable disposal provided either:

- the acquiring company B obtains more than 25% of the ordinary share capital of the target company A; or
- there is a general offer which, if accepted, would give the acquiring company B control of target company A; or
- where as a consequence of the exchange of securities, the acquiring company B holds the greater part of the voting power of target company A.

This section applies sections 127 to 131 (share reorganisations) with the necessary adaptations as if company A and company B were the same company and the exchange were a reorganisation of its share capital.

5.4.1 Example

Mr Adams subscribed for all 100 £1 ordinary shares in Adams Limited, an unquoted trading company for £100 in 1995.

In March 2007 Mr Adams sold his shares in Adams Limited to Bigco plc, a quoted company, for £1 million, the consideration being satisfied by the issue to Mr Adams of 250,000 Bigco plc £1 ords valued at £4 a share.

Assuming that the transaction was carried out for bona fide commercial reasons there would be no immediate chargeable gain on Mr Adams as this would appear to fall within section 135 TCGA 1992.

The new Bigco plc £1 ords would take over the CGT history of the old Adams Limited £1 ords and would thus have a base cost of £100 or 0.04 pence per share when the new shares are eventually sold.

Sale of Bigco shares before 6 April 2008:

If the shares are sold in March 2008, for example, Mr Adams would benefit from taper relief, from 6 April 1998 to March 2008. Business asset taper would accrue until March 2007 but the type of taper from March 2007 would depend upon whether Mr Adams is an employee of the Bigco plc group and/or whether the group qualifies as a trading group.

His gain would be (assuming full 75% taper relief):

Proceeds	1,000,000
Less cost / IA	(120)
Gain	999,880
Taper relief (75%)	<u>(749,910)</u>
Chargeable gain	<u>249,970</u>
CGT @ 40%	£99,988

Sale of Bigco shares after 5 April 2008:

If the shares are sold in, say, June 2008, Mr Adams may hope to benefit from entrepreneurs' relief. However, Mr Adams shareholding is less than 5% in Bigco and entrepreneurs' relief would be unavailable.

His gain would therefore be:

Proceeds	1,000,000
Less cost / IA	<u>(100)</u>
Gain	<u>999,900</u>
CGT @ 18%	£179,982

The section has effect subject to section 137(1) which specifies that the exchange of securities must be for bona fide commercial reasons and not part of a scheme or arrangements of which the main purpose or one of the main purposes, is avoidance of tax. However, persons holding 5% or less of any class of shares or debentures as a result of the exchange are not in any case denied relief by section 137.

Although not absolutely necessary the legislation provides the comfort of an advance clearance procedure that the conditions of section 137(1) are met. s.138 TCGA 1992

The case of a Mr Snell recently considered the tests of section 137(1). Mr Snell sold his shares in his family company in December 1996. Consideration for the shares was £7.3m of which £6.6m was in loan stock. Before redeeming his loan stock, Mr Snell moved abroad and became non-resident for tax purposes. He redeemed the loan stock in July 1997 and claimed that under s136 he rolled over the gain in December 1996 and the gain crystallised when he was not resident and not liable to CGT.

Snell v
HMRC
ALL
ER(D) 336

In terms of whether the transaction was carried out for bona fide commercial reasons, both the Special Commissioners and the High Court accepted that it was necessary to only look the transaction effected (the exchange of shares) If that exchange was for bona fide commercial reasons, which they agreed it was, it was not necessary to consider why Mr Snell had chosen to take loan stock rather than cash or shares.

But on the tax avoidance test, the judge considered, first, whether there was a scheme or arrangement and, second, whether the purpose was tax avoidance. On the first point, the judge concluded that there was a scheme or arrangement (a ‘plan of action’ or ‘combination of events’) linking Mr Snell becoming non-resident with the acceptance of loan notes and their redemption when non-resident. On the second, he found that on the basis of the evidence, the only purpose of the scheme was to avoid tax.

5.4.2 Paper-for paper opt out

Section 169Q (as inserted by Finance Act 2008) permits the dis-application of section 127 of TCGA. This allows disposers to “opt out” of Section 127 of TCGA – thus triggering an actual disposal on which relief can be claimed. A claim to entrepreneurs’ relief will automatically disapply section 127, thus crystallising a gain to which the relief will apply.

Section 169Q(4) states that the election must be made on or before the first anniversary of the 31 January following the tax year the reorganisation takes place. This means that for 2006/07 an election must be made by 31 January 2009 and for 2007/08 it must be made by 31 January 2010. A degree of retrospective planning is therefore possible assuming that the client has the funds to pay the CGT that is due as a result of making the election.

5.5 Acquisition for loan notes

Shares received under a paper for paper exchange can be relatively illiquid and it may be preferable therefore for individual shareholders to receive debentures or loan notes. The advantages, assuming certain conditions are met, are:

- deferring the liability to chargeable gains,
- phasing the disposal over more than one tax year in order to utilise several years worth of annual exemption (£9,600 for 2008/09) and
- the ability to claim entrepreneurs' relief

5.5.1 QCBs and non-QCBs

Loan notes can be divided between qualifying corporate bonds (QCB) and those which are not (non-QCBs). A QCB is exempt from CGT for an individual and therefore the 'roll-over' rules in section 135 do not apply to QCBs. s.115 TCGA 1992

Instead, where QCBs are issued in satisfaction of the proceeds on sale of shares, the indexed gain crystallises at the date of sale and is held over (or 'frozen') pending the redemption of the qualifying corporate bond. s.116 TCGA 1992

Further business reorganisation provisions in Finance Act 2008 in Section 169R TCGA 1992 allow for a disposal which qualifies for Entrepreneurs' Relief but under which QCB's are acquired to be treated as if the Entrepreneurs' Relief is applied to the gain on the initial disposal, so that only the net gain resurfaces on a subsequent disposal of the QCB's.

5.5.2 Transitional relief

A number of commentators expressed concern about those who had disposed of business assets on which taper relief would have been available, but had taken deferral relief, transferring the gain which would have arisen into a new asset. Of particular concern have been Qualifying Corporate Bonds (QCB's) and EIS and VCT investments (although deferral relief is no longer available in relation to VCT investments).

In all three of these cases, transitional relief is now available so that if the original disposal took place before 6 April 2008, and would have qualified for entrepreneurs' relief at the time of the disposal (had it existed) then the gain deferred is treated as the amount after entrepreneurs' relief. The claim will be made on the first disposal (or other occasion of charge) of the QCB or EIS / VCT shares after 6 April 2008. The relief is provided by paras 7 and 8 of Sch 3 to FA 2008.

Care is needed, however, as the transitional relief will only accrue to a holder of QCB's or other qualifying investments if they were the original disposer of the business assets. Where such investments have been passed, for example, to a spouse or civil partner, transitional relief will not be available. It is, however, open for the recipient to now pass those shares or bonds back to secure relief on a subsequent disposal.

5.5.3 Structuring a loan note as a non-QCB

- a right to subscribe for further loan notes,
- provision for a right to redeem, or expressing the notes, in a foreign currency,
- a right to convert into shares, or
- a right to interest which is dependent on the results of the business.

5.6 Deferred consideration and earn-outs

5.6.1 Capital Gains Tax Treatment

Ascertainable consideration at the time of sale is brought into charge immediately whether payment is deferred or not. For example, completion accounts prepared shortly after completion may determine the price paid for the shares at completion. s.48 TCGA 1992

If any part of the consideration is subsequently known to be irrecoverable, a tax repayment may be claimed.

Part or all of the deferred consideration may also be unascertainable. Earn-outs, for example, may be payable in cash or in paper, and are determined by reference to the performance of the business for a specific period after the acquisition.

In the case of *Marren v Ingles*, a right to receive deferred consideration was held to be a separate asset for CGT purposes. As a consequence, where a shareholder receives securities through an earn out provision on a take over, whilst there will be a CGT disposal on the ultimate disposal of the new shares obtained through the earn out there could be two earlier occasions of charge: 1980 STC 500

1. on the acquisition of the earn out right as part of the consideration for the original shares and
2. when the earn out right is disposed of in exchange for new shares.

5.6.2 Deferral of gain

Section 138A TCGA 1992 allows an earn out right in paper to be treated as a security and therefore the disposal is deemed to be paper for paper. This defers the gain on the receipt of the right to the earn out to the ultimate disposal of the new shares or loan notes earned through the earn out. The provision also clarifies the position where QCBs forms part of the earn out consideration.

Section 138A treats the earn out right as a security of the new company and as a non-QCB where:

- the earn out right is to be satisfied by the issue of shares or debenture in the take over company;
- as consideration for the transfer by the vendor of shares or debentures in the old company; and
- the value or quantity of new shares is unascertainable (probably hinging on the attainment of profit targets in Newco etc).

Therefore, if the paper for paper deferral provisions apply to the balance of the consideration (or would if appropriate), then the earn out right shall be treated as a security of the new company and as a non-QCB, hence the gain can be deferred.

The relief is automatic but can be disappplied by election. Obviously the decision as to whether or not to elect must be considered in great detail and will be influenced as to the availability of losses on the initial/subsequent disposal.

5.6.3 Loss carry back

Section 279A TCGA 1992 is another valuable provision where earn out is received in cash. If a loss arises on the ultimate earn out, S279A provides a carry back of that loss against the gains arising on the receipt of the earn out right. Note that S279A is not available where S138A applies.

5.6.4 Example

Ernie Wright sold his shares in his trading company to a competitor on 1 February 2005. The terms of the deal were that Ernie received £500,000 cash immediately plus further cash in two years time dependant upon the future profits of the business. The amount of the future cash was determined by a formula that would provide an amount ranging from nil to £2 million in cash.

The net present value of the right to the future consideration was agreed with shares valuation division at £500,000 and consequently Ernie would be charged to capital gains tax on £1 million consideration (£500,000 cash now plus the value of the earn-out right).

The right to the future consideration (a chose in action) is treated as a new asset acquired at the time of the deal and accrues business taper at the non-business rate, i.e. none unless held for at least 3 years.

Let us assume that the amount that Ernie receives in 2007 under the earn-out formula is only £200,000. This would mean that Ernie realises a capital loss of £300,000 on the new asset acquired. S279B enables the loss to be set against the earlier gain.

However, this still leaves a decision to be made in the case of share sales as to whether to take the deferred consideration or take loan notes (QCBs or non-QCBs).

5.6.5 Stamp duty

Clearly, if an amount of consideration is unascertainable at the time of transaction, there would be difficulty, without specific rules, to calculate the correct amount of stamp duty payable.

The ‘contingency principle’ therefore intervenes to provide certainty. The rules operate as follows:

- where a stated amount may increase or decrease, stamp duty is payable on the stated amount
- where a minimum amount is stated (and no maximum), stamp duty is payable on the minimum amount, and
- where a maximum amount is stated, stamp duty is payable on the maximum amount.

Consideration for shares which is wholly unascertainable is not chargeable. However, this may be challenged by Stamp Office who may wish to refer to the market value of the shares at completion in assessing the duty (following the decision in *LM Tenancies 1 plc v CIR* (1998) STC 326).

Treatment is different for consideration that is undetermined but ascertainable at the time of completion. For example where the consideration is to be ascertained by reference to the completion accounts prepared perhaps several months later. In that case, stamp duty is assessed on the amount of consideration subsequently ascertained.

5.6.6 Employment related securities

Where the seller of a business was also a director or employee of the business and/or becomes a director or employee of the acquirer there is risk that if not properly structured all or part of the earn out may be taxed as employment income if received by virtue of the individual’s employment.

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Where an earn-out operates entirely to cover further proceeds of sale, with no element of remuneration, then Income Tax and National Insurance Contributions (NICs) should not be payable. But where an earn-out includes an element that passes value to a prospective employee of the acquiring company as reward for services over a performance period, then that remuneration element could be within the charge to Income Tax and NICs.

HMRC’s Employment Related Securities manual confirms that when an earn out takes the form of a right to acquire securities at some time in the future

subject to conditions, it will, for the purposes of Chapter 5 ITEPA 2003, be a 'securities option'. However, where the purchaser of a company has the choice of paying the earn-out in cash or securities, then it will not be a securities option.

The manual goes on to say that employees in receipt of such securities options may continue to work for the business or cease their employment. Employees who continue to work for the business will have acquired a securities option from their prospective employer and the legislation deems this to be 'by reason of employment'. But it also stresses that employees who cease to work at the time the business is sold may also be deemed to have acquired their option 'by reason of employment'

Assuming Chapter 5 applies for both categories there will be a potential liability to Income Tax and NIC on the receipt of the earn-out securities. However, where it can be shown that the earn-out is further consideration for the disposal of securities rather than value obtained by reason of employment, the value of securities exchanged for the earn-out will be taken to be equal to the value of the securities acquired under the earn-out itself. There will then be no liability to Income Tax arising.

The Revenue's manual offers further guidance by highlighting the following key indicators in determining whether an earn-out is further sale consideration rather than remuneration are:

- a) The sale agreement demonstrates that the earn-out is part of the valuable consideration given for the securities in the old company
- b) The value received from the earn-out reflects the value of the securities given up.
- c) Where the vendor continues to be employed in the business, the earn-out is not compensation for the vendor not being fully remunerated for continuing employment with the company.
- d) Where the vendor continues to be employed, the earn-out is not conditional on future employment, beyond a reasonable requirement to stay to protect the value of the business being sold.
- e) Where the vendor continues to be employed, there are no personal performance targets incorporated in the earn-out.
- f) Non-employees or former employees receive the earn-out on the same terms as employees remaining.

The following factors may also be relevant:

- g) Negotiations between the seller and buyer as to the level of the earn out in relation to the value of the consideration given for securities in the old company.

- h) Any clearance that might have been obtained under Section 138 and Section 707 demonstrating the bona fide nature of the transactions, and the level of the earn-out linked to profitability or other key performance indicators of the business.
- i) Evidence that future bonuses were reclassified or commuted into purchase consideration would indicate that the earn-out was, at least partly, remuneration rather than consideration for the disposal of securities.

Where the earn-out is partly deferred consideration for the old securities and partly a reward for services or inducement to continue working for the business, then an apportionment of the value will need to be undertaken on a just and reasonable basis.

This guidance is only applicable to the computation of earnings under Chapters 2, 3 or 5 Part 7 ITEPA 2003 and has no bearing on the rules for Capital Gains Tax.

6. Tax Planning in a Recession

6.1 Recession-proofing clients: cash conservation for corporates/businesses

In tighter economic times, clients will be more focused on cash flow and ways of holding on to their cash for longer, or getting it in quicker. Below are some basic tax ideas for improving cash flows.

As ever there are other considerations to think about. For example, if the action gives rise to a repayment, the new Finance Act 2008 rules that allow set off between different taxes must be considered as the client may not receive the cash expected and may simply have the refund set off against another tax liability. Also some of these ideas may depend on the accounting treatment being appropriate and so clients will need to know sooner rather than later if there is an impact on the accounts.

So here is an aide memoire of issues that you may want to talk to your clients about:

Research & Development (R&D) tax relief

Extension of small and medium sized enterprise (SME) definition, makes enhanced deductions and payable credits available to larger companies, ie

- fewer than 500 employees
- annual turnover not exceeding €100m **and/or** balance sheets not exceeding €86m

Share schemes

Pay rises in equity - Enterprise Management Incentives (EMI) or Joint Share Ownership Plan (JSOP) if not EMI qualifying.

If a company does not qualify for EMI (eg controlling corporate/Venture Capital investor, > 250 employees or individual) then consider other options eg

- flowering share scheme - private companies
- JSOP - public companies.

Review payments on account (POA) and quarterly instalment payments (QIPs)

Detailed profit calculations to minimise POA

Repayments may be available if profits turn into losses

Avoid being caught in the QIPs regime - ideas include:

	ideas include:
	<ul style="list-style-type: none"> ▪ change accounting periods (SI 1998/3(6)(b)) and lengthen 'grace periods' ▪ post acquisition review hive up strategy to ensure activities moved do not push recipient companies in to QIPs ▪ 'manage' profits to keep company out of QIPs (bonuses, capital allowances, specific provisions, transfer pricing).
Interest to foreign parent deductible on accruals basis	Consider interim changes to late interest rules in order to claim deductions earlier
Tax favoured capital allowances (CAs)	Enhanced CAs on energy saving and water saving equipment (plus claim payable credits for loss making companies) <ul style="list-style-type: none"> ▪ R&D allowances on equipment used for R&D at 100% ▪ Consider timing of capital expenditure to maximise availability of the Annual Investment Allowance
Long life assets v standard CAs	Review expenditure and accounting to maximise 20% allowances and minimise long life assets at 10%
Short life asset elections	Accelerate tax deductions
VAT - cash flow planning	Manage VAT payments, think about accruals and VAT grouping.
Transfer pricing (TP)	Move cash within the group through appropriate TP Manage tax rates through appropriate TP
Provisions - FRS12	Ensure provisions are compliant with FRS12 to get a tax deduction - often the client struggles to provide sufficient information.
Decontamination costs	150% relief for costs of decontamination, especially developers of brownfield sites

	of brownfield sites
Bonus provisions paid within 9 months	Defer bonuses by up to 9 months post year end - to ensure deductions, pay within 9 months
Loss carry-back	<p>If the current year is loss making then submit returns as soon as possible to generate a repayment of tax</p> <p>Any scope for provisional repayments if management accounts showing loss in current year?</p>
Employee remuneration packages	It should be possible to restructure the pay and benefits package in a cost and tax-efficient way, while at the same time ensuring that employees are properly remunerated and rewarded for their efforts – not just in terms of salary but via other benefits, such as flexible working and additional holidays
Online filing and payment of PAYE and VAT	Online filing and payment of VAT and PAYE can extend the deadline for payment by a few days

Article by Francesca Lagerberg

6.2 Tax implications when a company lends money to a director

Directors have commonly ‘borrowed’ funds from their companies. What are the various tax implications of loans to directors?

6.2.1 Company law

To give an overview – it is not possible for a company to make a loan to a director or indeed to provide a guarantee or security in respect of a loan without approval by way of a resolution from the members of the company.

Naturally there are a number of exceptions, for example providing funds to the director to enable him to meet expenditure incurred by the company where that expenditure does not exceed £50,000.

6.2.2 Consequences of loans to directors

Both the director and the company suffer tax consequences of loans being made or indeed written off. The relevant provisions relating to the director’s tax position are contained in the ‘benefits code’ and for the company within TA 1988, s 419 to s 422.

6.2.3 The director's tax position

Where a director obtains an 'employment related loan' and that loan is a 'taxable cheap loan', the cash equivalent of the loan is treated as earnings for that year subject to a number of exceptions.

These provisions do not apply to a loan in any tax year where the loan itself would have been a qualifying loan.

The rules apply equally to an overdrawn director's loan account.

To cover the position of smaller loans there is a de minimis exemption where the amount is not treated as earnings, provided the loan does not exceed £5,000 at any time during the tax year.

Additionally, expense advances are ignored provided the maximum amount outstanding does not exceed £1,000, the advances are spent within six months and the employee makes regular accounts to his employer evidencing the expenditure.

6.2.4 Calculation of the interest

There are two methods of calculation permitted, the 'normal averaging method' and the 'alternative precise method'. The normal averaging method is used except where HMRC require the alternative method or the individual concerned elects to use it. Notice must be given within twelve months of the self assessment filing date for the particular tax year concerned.

The benefit is reportable on the employer's form P11D for the year and Class 1A National Insurance contributions are payable by the employer at 12.8% on the cash equivalent with the director paying tax through his self assessment.

6.2.5 Loans subsequently written off

A loan ceases to be outstanding on the death of the director, but what of the situation where the employer decides to write the loan off?

Where a loan is written off, the director is no longer obliged to repay this and a tax charge will arise irrespective of the terms of the loan that has been written off.

Generally, any of the amount written off is taxable as income of the employment in the year it is written off; but for controlling director/shareholders special rules apply preventing the company from having a deduction against tax and treating the amount written off as a distribution.

National Insurance contributions should operate on the amount written off even if it is a shareholder loan.

6.2.6 The company's tax position

Additionally, there are tax implications for the company if it is a close company and the director is a 'participator' or associate of a participator.

Where such a loan is made, the company must notify HMRC within twelve months of the accounting period end in which the loan is made and must pay a

25% tax charge on the amount of the loan or indeed the balance of the overdrawn loan account if one exists.

Any tax found to be assessable is payable nine months after the end of the accounting period in which the loan is advanced unless the loan is repaid prior to this date.

It is possible for companies to claim a repayment of this s 419 tax if the loan has been repaid before the tax payment date, or by set off if the loan is repaid before the nine-month payment date.

However, if the loan is not paid by the repayment date, it will not be recoverable until nine months after the end of the period in which it is repaid.

6.2.7 Overdrawn loan accounts

It is often the case that a director's loan account is overdrawn and the company has an obligation in accordance with UK by the year end to pay further remuneration which will eventually be used to clear the balance.

The accounting entries will show 'debit director's remuneration and employer's National Insurance contributions' and 'credit accruals' provided the relevant accounting standards requirements are met for a valid liability to be recorded.

This additional remuneration is not, however, available to the director in accounting or tax terms at this stage and is not a credit to the director's loan account. If we assume that the accounts are prepared within the next three months and the quantum of the bonus then ascertained followed by a board meeting affirming the bonus, it will be at that point that the remuneration will be available and hence subjected to PAYE in the hands of the director and the credit recorded.

6.2.8 Paid and available

The misconception that remuneration is credited against the loan account, in this example, at the year end rather than when available can lead to significantly incorrect calculations of beneficial loans, s 419 tax and PAYE deductions.

It would also be best advice to have a board meeting with actions formally minuted before the year end evidencing the intention to pay a bonus, otherwise HMRC may argue that remuneration may not be deductible in calculating the taxable profit for the period.

If the board's actions make the additional remuneration available to the director, it should also allow earlier credit to the director's loan account, but will hasten the payment of PAYE.

For completeness sake, it should be noted that it may also be possible to clear a director's loan account by voting a dividend rather than paying remuneration, provided the company has sufficient distributable reserves to do so.

From an article by Penny Bates writing in Taxation

6.3 Redundant or given the sack!

An employment relationship can end for a variety of reasons. It is worth examining the most frequent of these, looking at the tax treatment of associated payments.

6.3.1 Termination by resignation

Where an employee resigns there will normally be no compensation payment in respect of the termination of the employment relationship, but the matter of notice may be in play.

If he serves his notice, all payments including wages or salary, overtime, holiday pay, bonuses, etc. will be subject to the deduction of tax and National Insurance contributions under the PAYE regime as normal.

If he does not serve out his notice period, he may either be asked to go on 'garden leave' or be paid an amount in lieu of the period, and cease employment immediately thereafter.

Garden leave: All payments to the employee remain subject to deductions under PAYE as if he had continued to attend the office.

Payment in lieu of notice: A PILON which flows from a term of the contract of employment will be subject to the deduction of tax and NICs as they fall within the definition of 'earnings' as prescribed by ITEPA 2003, s 62.

It is important to mention at this point that the absence of a contractual right to a PILON will not in all cases be a defence from an attack by HMRC, who have in the past sought to tax as earnings payments made on termination of employment where the employer has a 'custom and practice' of making such payments on the cessation of employment.

HMRC argue that where there is a reasonable expectation on the part of an employee that despite the absence of a contractual entitlement, he will receive a PILON instead of being allowed to work out his notice period, a contractual term will be implied and PAYE will be due on the payment.

6.3.2 Termination by dismissal for poor performance or gross misconduct

If the employee is served with notice to terminate the contract of employment, and they serve out their notice, then PAYE will flow as discussed above.

In reality, however, most dismissals of this nature are followed by either a period of garden leave or the making of a PILON which may or may not be taxable depending on whether or not there is a contractual right – express or implied (see above).

If a PILON clause exists and the employer does not allow the employee to serve out the notice period, a breach of contract will have occurred and any subsequent compensation payment will not be treated as earnings but will be taxed under ITEPA 2003, s 401.

In the event of gross misconduct leading to a summary dismissal, there will normally be no provision within the contract for a PILON and the employer

will not be obliged to compensate the employee for the termination of the employment relationship.

Any payment made on termination will therefore be deemed to be earnings, unless there is an argument for damages related to a failure to comply with the aforementioned procedures under Employment Relations Act 2004, in which case taxation under s 401 will be triggered.

6.3.3 Termination by mutual agreement

In exceptional circumstances, an argument may be made for the agreement by both parties to the mutual termination of the contract of employment.

The possible reasons for this are many and varied and may be outside the scope of this article. Where these occur, any payment made on the cessation of the employment will require careful analysis before a decision is made on whether or not the payment should be treated as taxable within the scope of ITEPA 2003, s 62 or s 401.

6.3.4 Redundancies

Put simply, where an employment relationship is terminated by redundancy as defined by the Employment Rights Act 1996, s 139, a redundancy payment may follow.

An employee will qualify for statutory redundancy payment if he has the required minimum of two years' service (see ERA 1996, s 139). The payment will not be earnings for the purpose of ITEPA 2003, s 62 as it is exempted by ITEPA 2003, s 309, but it will be taxable under the provisions of ITEPA 2003, s 401.

Any payment in respect of restrictive covenants, holiday, terminal bonuses, et al, will remain taxable as contractual payments. Restrictive undertakings may be reinforced in any payment on termination, but this will be subject to tax under ITEPA 2003, s 225.

6.3.5 Tax planning opportunities

There are a number of ways in which an employer can mitigate the costs of a payment on termination of employment, as certain types of payments that might be made when an employment ends are exempt from taxation under s 401.

- ITEPA 2003, s 271. Useful in limited circumstances, this refers to the making of payments in respect of removal costs that arise as a result of a change or termination of duties.
- ITEPA 2003, s 406. Payments on death or disability
- ITEPA 2003, s 407. Payment by the employer of contributions to a tax exempt pension scheme
- ITEPA 2003, s 413. Foreign service deduction.

Conclusion

In summary, the point is made here that provided the right conditions are met, a payment made in compensation for loss of office will be taxed under ITEPA 2003, s 401 not s 62.

Attention must be paid to establish that what is being paid out is compensation for loss of office, or in lieu of serving notice.

To this end, clients are advised to consider looking at the various components of the payments that they propose making to their employees and to then analyse these to ensure that a distinction is made between payments that are prima facie taxable because they are either a contractual (express or implied) entitlement and those payments that are made in respect of compensation – whether that be damages for breach of contract, loss of employment, or payments that the employee is not entitled to receive under his contract.

Once taxation under s 401 has been established – as noted above – a number of further provisions may provide planning opportunities for tax on amounts over and above the £30,000 limit set out at ITEPA 2003, s 403(4).

From an article by Femi Ogunshakin writing in Taxation

6.3.6 Ex gratia or not?

In 1996 the company was formed as part of the Lloyd's reconstruction and renewal plan to reinsure various long-tail liabilities of Lloyd's and it was set up with the intention of “working itself out of business”.

In November 1996 H, a US national, was employed by the company as director of human resources. Once it achieved its business objectives the company began to downsize and H's job changed from managing high volume staff recruitment and establishing human resources policies for the business to managing a planned headcount reduction programme over a five-year period. Thus, by 2004 H's role was very different from her original role and realising that her task had been accomplished she formally resigned on 21 July 2004. In so doing she forfeited her potential redundancy benefit, assessed to be £152,300, and outstanding long-term incentive plan awards, amounting to £122,500, she would have received had she remained. Whilst there was no provision in her employment contract under which she was entitled to an ex gratia payment, the CEO of the company decided to make her an ex gratia payment of £150,000 to compensate her for the benefits she was giving up as a result of her resignation and to recognise that she was doing the “right thing” by the company. H left the company on 17 September 2004 and returned to California. On 19 November 2004 the company made the ex gratia payment into her American bank account. The company deducted tax at the basic rate of 22 per cent from £120,000 of the payment.

HMRC contended that the ex gratia payment was chargeable to tax as general income from the employment under ITEPA 2003 s 62(2)(b) and amended H's self-assessment tax return for 2005 and issued a determination on the company under the Income Tax (Pay As You Earn) Regulations 2003, SI 2003/2682, reg 80. H and the company appealed. The company argued that the ex gratia payment was not chargeable under s 62 but only under ITEPA

2003 s 401 as a payment in connection with the termination of H's employment and that on that basis it had deducted and accounted for the correct amount of tax. H submitted that (a) she was not employed by the company when the payment was made and she had no contractual or other legal entitlement to it and had the company refused to pay it there would have been no formal recourse open to her. Furthermore the payment was not paid in connection with the termination of her employment. It was a straightforward personal gift—made because she had “done the right thing” by the company in resigning—and not chargeable to tax at all; or, in the alternative, (b) if it was a termination payment within s 401, it was not subject to UK income tax because it was not “salaries, wages, and other similar remuneration derived by a resident of a Contracting State in respect of an employment” within the UK/USA Double Taxation Convention 2001, art 14; thus the payment could only be “other income” within art 22 and therefore taxable only in the USA.

The Special Commissioner found that the *ex gratia* payment was not earnings for the purposes of ITEPA 2003 s 62 as it was paid in recognition of the fact that H had “done the right thing” in resigning her position as human resources director with the company. On the facts the *ex gratia* payment was truly *ex gratia*. H had no contractual entitlement to it and she did nothing to earn it in the conventional sense. Whilst it was true that the company would not have paid it had she not chosen to resign her position, it was not paid in return for that resignation. However, a gratuity or gift was not removed from charge to tax as employment income by that fact alone. It was possible that had there been no financial cost to H's decision to resign voluntarily the company CEO would not have thought of making the *ex gratia* payment. Although companies did not usually pay gratuities to employees who chose to leave voluntarily, they might do to recognise the personal qualities that an employee had exhibited in the course of that employment. When judges referred in that context to the payment being for “something else” they did not necessarily have in mind payment for some other (non-employment) service or asset. It might be an intangible personal quality of the individual concerned—loyalty, good humour, for being a good team player—that contributed significantly to the success of the business and therefore were appropriately recognised gratuitously. However, a payment did not lose its character as earnings because it was paid to recognise the personal qualities that the employee had exhibited in the course of rendering services. The payment remained earnings for employment services even if it purported to be for rendering the services with a smile. That was not the case, however, when the personal quality involved was recognising that the time had come to leave. H had recognised that her job was done and that she should move on to other things. The payment was made for “doing the right thing” by the company and resigning voluntarily; it was not in respect of any service that H had rendered or that she was obliged (but for short notice) to render.

The Special Commissioner found that the *ex gratia* payment was a termination payment within ITEPA 2003 s 401. The language of sub-s (1) was cast in the widest terms designed to catch any payment or benefit received “directly or indirectly ... in consequence of, or otherwise in connection with” the termination of H's employment. The payment might have been gratuitous and

for “doing the right thing” but the right thing was resigning her employment. Accordingly the payment was in consequence of or in connection with the termination of her employment.

However, the Special Commissioner found that the ex gratia payment was not within the scope of the UK/US Double Taxation Convention 200, art 14. As the ex gratia payment was a gift “for doing the right thing” it did not fall within the ordinary meaning of the words “salaries, wages and other similar remuneration”. Whilst “other similar remuneration” was capable of extending to any reward that a person derived in respect of their employment services, whatever form it took, including termination payments such as PILONs, and “remuneration” was a wider term than salary and could envisage anything that a person got for his services, remuneration still involved the concept of something that was given quid pro quo for services rendered. In the present case, the only thing which could be described as a quid pro quo was the fact that H had voluntarily resigned her position. An ex gratia payment that the company chose to make following a resignation in those circumstances could not be described as remuneration in any ordinary sense of the word. It was not solely the fact that it was ex gratia but that the payment lacked the necessary nexus with services rendered that usually characterised payments as salary, wages or other similar remuneration. Furthermore, there was nothing in the context of ITEPA 2003 or in the language of the Convention to indicate that art 14 of the Convention should be construed as encompassing anything that fell within the charge to tax under Sch E or within ITEPA. Therefore the gratuitous payment should not be treated as within the Treaty concept of “salaries, wages and other similar remuneration” just because it happened to be taxed by the UK as an amount that counted as employment income. It followed that since art 14 did not apply to the ex gratia payment, the portion of the ex gratia payment (ie £120,000) that would otherwise be charged to UK tax was nevertheless exempt by virtue of the UK/US Double Taxation Convention 2001, art 22(1). Accordingly the appeals of H and the company would be allowed.

Appeals allowed

Resolute Management Services Ltd v Revenue and Customs Commissioners;
Haderlein v Revenue and Customs Commissioners SpC 710

6.4 A Guarantor v Revenue and Customs Commissioners SpC 703

The appellant was a director of the company and held 5% of the issued shares. The company was in acute financial difficulty and in September 2002 it entered into a debt factoring agreement which obliged its directors to enter into personal guarantees in amounts which were proportionate to their respective shareholdings and was binding on them for a four month period after resignation from office. The appellant resigned the same month and left the company.

Unfortunately, the company failed in December 2002 and the appellant's guarantee was called upon. In November 2004 the appellant paid £12,972 in

respect of the guarantee. In his tax return for the year to 5 April 2005 the appellant claimed a deduction for the payment under ITEPA 2003 s 336(1).

HMRC disallowed the claim and the appellant appealed contending that, as a company director, he was obliged to enter into the guarantee. The company was in financial difficulty and he had a duty, as a director, to its creditors, employees and shareholders to maintain its solvency. If, as in the present case, there was only one available means to achieve that objective, it followed that the expenses incurred by a director when availing himself of those means were wholly and necessarily incurred in the course of his employment. HMRC submitted that (i) the expense in the present case did not fulfil any of the conditions in s 336(1)—it could not be said that every director of a company was obliged to guarantee the company's debts, indeed until September 2002 the appellant, though a director of the company, did not guarantee its debts. Since it was not the duty of a director to guarantee a company's debts, it could also not be said that the expense was necessarily incurred in the performance of his duties. It might be the case that, had the directors refused to enter into the guarantees, the company would have ceased to exist, but that was a consequence of its poor financial position; the directors could perform their duties as directors without entering into guarantees. Guaranteeing the company's debts might have enabled the company to continue to trade, and to that extent it enabled the appellant to perform his duties, but it was not something he did in the course of those duties; (ii) the appellant had incurred none of the expense for which he now claimed relief in the course of his employment. Whilst he ceased to be a director in 2002, he did not incur any expense until he made the payment in November 2004. He had no more than a contingent liability when he left office; by the time it crystallised he was no longer in that employment, and it could not be said that the expense was incurred in the course of carrying out his duties; (iii) even if all the other relevant conditions were satisfied, the expense had not been incurred wholly and exclusively for the purposes of the appellant's employment since, whatever his primary purpose and motive in entering into the guarantee, it also had the purpose of protecting his investment in the company and his own position as its director and employee; and (iv) the appellant had sought relief under the wrong provision as there was a tailor-made provision under TCGA 1992 s 253, which in itself was a clear indication that ITEPA 2003 s 336(1) was not intended to afford the relief sought.

The Special Commissioner considered that the appellant was not entitled to claim relief under ITEPA 2003 s 336(1) in respect of the payment made under the personal guarantee. It was an inescapable conclusion that the expense, as distinct from the contingent liability, was not incurred in the course of his employment, but only after it had come to an end, with the consequence that it could not be said that the expense was incurred in the course of the employment; and that the appellant gained some benefit, albeit in the event very short-lived, from the company's ability to trade. Indeed, the very fact that, by entering into the guarantee, the taxpayer discharged his duty as an officer (rather than an employee) of the company bestowed some benefit on him. It followed that the appeal would be dismissed.

EAST MIDLANDS CIOT & ATT – Events for 2008/2009

Date	Details	Timetable	Venue
Tuesday 9 December 2008 6.00pm – 8.00pm Cost: £15.00 CPD Hours: 1.5	The New Penalty Regime & Tax Investigations Update Paul Lynam Lynam Tax – Positive Tax Solutions	6.00pm - Registration & refreshments 6.30pm - Lecture starts 7.45pm - Questions & informal discussion 8.00pm – Close	PricewaterhouseCoopers Offices Donington Court Pegasus Business Park Castle Donington, Derbyshire
Tuesday 10 February 2009 4.00pm – 8.00pm Cost: £40.00 CPD Hours: 3	Charity Update – accounts, law & tax Rebecca Benneyworth BSc FCA Tax writer & lecturer Lexis Nexis Tax Lecturer of the year 2007	4.00pm - Registration & refreshments 4.30pm - Lecture starts 6.00pm - Break for refreshments 6.15pm - Lecture resumes 8.00pm – Close	The Novotel Nottingham/Derby Junction 25 M1 Bostock Lane Long Eaton Nottingham
Tuesday 10 March 2009 4.00pm – 8.00pm Cost: £40.00 CPD Hours: 3	Property Tax Update By Brian Ogilvie FCCA CTA Freelance Tax Lecturer & Consultant	4.00pm - Registration & refreshments 4.30pm - Lecture starts 6.00pm - Break for refreshments 6.15pm - Lecture resumes 8.00pm – Close	Best Western - Leicester North (formerly the Comfort Inn) A46 Fosse Way Upper Broughton Leicestershire
Wednesday 22 April 2009 4.00pm – 8.00pm Cost: £40.00 CPD Hours: 3	The Interaction between Accounting Standards & Tax By Andrew Guntert MSc FCA Lecturer for Mercia	4.00pm - Registration & refreshments 4.30pm - Lecture starts 6.00pm - Break for refreshments 6.15pm - Lecture resumes 8.00pm – Close	Premier Inn, Braunstone Lane East Leicester
Wednesday 20 May 2009 4.00pm – 8.00pm Cost: £40.00 CPD Hours: 3	Finance Bill 2009 Mark Morton BA ATII ATT Senior Tax Lecturer for Mercia	4.00pm - Registration & refreshments 4.30pm - Lecture starts 6.00pm - Break for refreshments 6.15pm - Lecture resumes 8.00pm – Close	Best Western - Leicester North (formerly the Comfort Inn) A46 Fosse Way Upper Broughton Leicestershire
Date to be advised 6.00pm – 8.00pm Cost: £15.00 CPD Hours: 1.5	Topical Tax Issues Andrew Hubbard BMus PhD ATT CTA (Fellow) Tax Director, Tenon Group PLC	6.00pm - Registration & refreshments 6.30pm - Lecture starts 8.00pm – Close	PricewaterhouseCoopers Offices Donington Court, Pegasus Business Park, Castle Donington, Derbyshire

The Branch Committee reserves the right to alter the above programme without prior notice.

For more details of any of the above events or to book a place please contact the Branch Secretary, Martin Tomes at
Greenhalgh & Co.
2A Peveril Drive, Nottingham. NG7 1DE
Telephone: 0115 985 9517 or E-mail: martin.tomes@greenhalghco.net



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