client briefing

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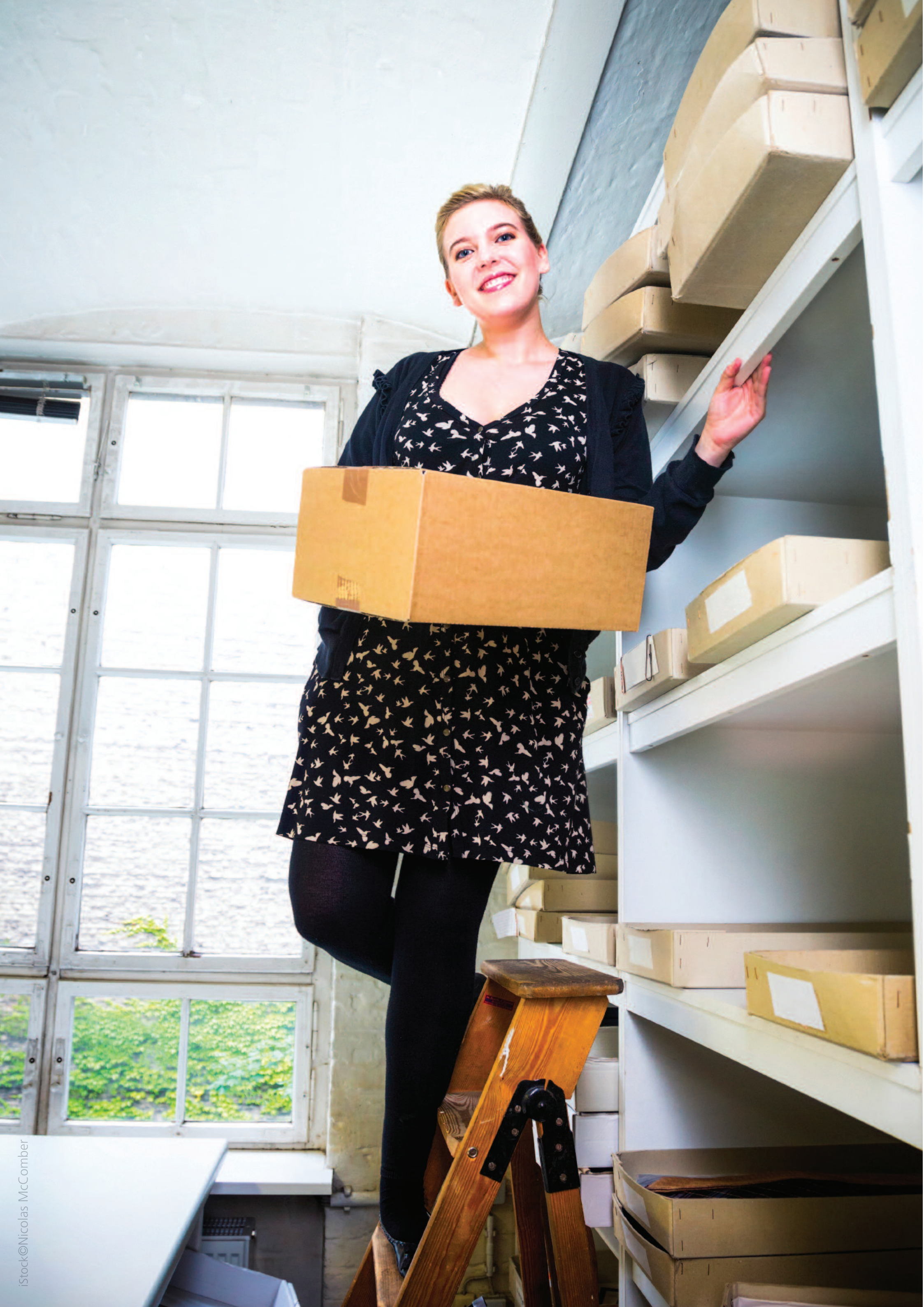


Two steps forward for business – and one step back

The Chancellor insists that "Britain is open for business," and his March 2013 Budget contained two measures that will be of interest to businesses large and small – even though you will have to wait for them to take effect. But now a measure in last year's Budget has just started to bite.

One of the items of good news is the introduction of a unified rate of corporation tax. For the current financial year, the small profits rate is 20% and the main rate is 23%, while profits between £300,000 and £1.5 million suffer an effective marginal rate of 23.75%. Next year, the main rate will come down to 21% and the marginal rate will be 21.25%, before the single unified 20% rate applies from 1 April 2015. This is quite a drop from the top marginal rate of 32.75% that was charged just a few years ago.

The second bit of good news will particularly benefit smaller businesses. This is the new annual £2,000 employment allowance which, from April 2014, all businesses will be able to set off against their national insurance contributions (NICs) bill. At current rates, a business will be able to employ four workers on the minimum wage without any NICs cost.

The employment allowance could change the 'salary versus dividend' decision for owner-managed companies, which currently is heavily skewed in favour of dividends. It narrows the difference, but dividends still win out. Assuming an initial salary near the NICs threshold, in the region of £16,500 of additional profits could be withdrawn as salary, with employer NICs covered by the employment allowance.

At the moment, a basic rate taxpayer can save about £3,300 if they choose the dividend route. The difference comes down to around £2,000 if the employment allowance is taken into account, so a significant cost will still be attached to the salary option. The difference will completely vanish for those over state pension age who do not pay employee NICs.

The decision to incorporate will depend on the level of profits, and how those profits are withdrawn after incorporation. With a profit level of £40,000, a self-employed person would have a total tax and NICs bill of a little more than £9,000. The bill would currently be just over £10,000 if the business was incorporated, with £25,000 withdrawn as salary. The £2,000 employment allowance will therefore reverse the outcome.

And then comes the bad news. Of more immediate concern for entrepreneurs is the limit that now applies to setting off loss relief and getting a tax deduction for loan interest. The limit is set at the higher of £50,000 or 25% of income. It may be possible to restrict the impact of the limit on deductible losses by disclaiming capital allowances, and it is important to understand that any restricted loss can still be carried forward and relieved against future profits.

But the limit will have more serious implications where it restricts the deduction of loan interest, because the tax benefit of any restricted interest will be permanently lost. This might be a continuing problem, and could mean that individual borrowers will need to restructure their finances as a matter of urgency. Please contact us if you think you may be affected.

Which way for the state pension?

The state pension system is the subject of some radical reforms, with the current two-tier state pension being replaced with a new single-tier pension that is higher than the current basic state pension. One of the aims is to eliminate the need for means-tested pension credit.

Current system

The current state pension system is made up of two elements.

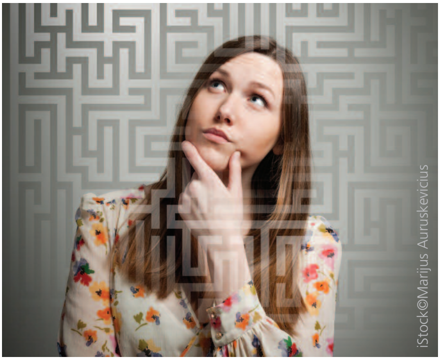
The basic state pension (BSP) is normally paid from the date when you reach state pension age (SPA), which varies according to your sex and date of birth. You currently need 30 qualifying years' worth of national insurance contributions (NICs) in order to qualify for the full BSP, which for 2013/14 is set at £110.15 a week for a single person. You can defer the start date to receive a higher pension or a taxable lump sum.

The state second pension (S2P) is related to your actual or deemed earnings and provides a top-up to the BSP. S2P was the successor of the state earnings related pension scheme (SERPS). Self-employed people do not qualify for S2P, and in the past many employees have been contracted out of S2P/SERPS through their membership of various occupational or personal pension schemes.

New system

The single-tier pension will be introduced from 6 April 2016 – one year earlier than originally announced. You will receive it if you reach your SPA on or after the start date. However, if you reach your SPA before then, your pension will be paid under the existing rules and you will continue to receive the BSP and, if you qualify, S2P/SERPS as well.

The amount of the single-tier state pension will be decided shortly before it is introduced and it will be set above the level for means-tested support (£145.40 a week in 2013/14). To qualify for the full single-tier state pension



you will need 35 qualifying years' worth of NICs. It will still be possible to defer starting to receive the new single-tier pension, but you will only be able to earn extra pension, not a lump sum.

Moving to the new system

If you will reach your SPA after the start of the single-tier pension, your national insurance records under the old system will be translated into a simple single-tier starting amount, known as 'the foundation amount.' If you have a foundation amount less than the full level of the single-tier pension, you will be able to build up entitlement to the full level. If your foundation amount is more, you will receive the foundation amount, inflation adjusted, but not accrue any further state pension under the new system.

End of contracting out

The abolition of the S2P will bring an end to contracting out. If you are a member of a contracted-out salary-related occupational pension scheme, you will pay the full NICs rate once the single-tier pension is introduced.

‘Employee shareholder’ to go ahead

A controversial new employment status, ‘employee shareholder’, will now become law after the House of Lords accepted final concessions.

The idea is to encourage employee share ownership under a ‘rights for shares’ scheme whereby those adopting the status receive tax advantaged shares in exchange for giving up certain employment rights.

Employee shareholder status is intended to be a new category of employment. An employee who becomes an employee shareholder will be allotted or issued with at least £2,000 worth of shares in their employer’s company. The shares will form the consideration element of the employee shareholder agreement, and in return for them the employee shareholder will forfeit some of their employment rights.

The first £2,000 worth of shares is free of tax and national insurance contributions. Corporation tax relief is available for the cost of the shares allotted under the agreement. Any gain on the disposal of up to £50,000 of employee shareholder shares is exempt from capital gains tax.

The tax advantages are subject to a number of conditions and there are various anti-avoidance measures to prevent exploitation.

The shares come at a price. Those who adopt the new employee shareholder status are required to forfeit certain employment rights in exchange for the shares. This has proved to be controversial.

For example, an employee shareholder can be unfairly dismissed (except where the dismissal would be automatically unfair, such as for whistle-blowing) and also does not have the right to:

- request time off for training;
- request flexible working;
- receive a redundancy payment.

In addition, an employee shareholder must give 16 weeks’ notice, rather than the usual eight weeks, of their intention to return to work early after maternity or additional paternity leave.

The House of Lords finally accepted a concession requiring an individual to obtain advice from a relevant independent adviser before entering into the contract, clearing the way for the proposals to become law.

The intended start date for the new employee status is 1 September 2013. This is, however, dependent on the necessary legislation making it to the statute books.

Tracking down missing homes

The latest 'anti-avoidance' campaign is aimed at people who have undeclared capital gains from disposals of residential property, either in the UK or abroad.

Such a gain could have arisen on a holiday home, a property that has been rented out, or even a main home that has been sold without full private residence relief. Anyone who decides to take advantage of this campaign must inform HMRC of their intention to make a disclosure by 9 August 2013, and make the disclosure itself by 6 September 2013 – which is also the deadline for paying the outstanding tax.

The gains covered by the campaign are primarily those made between 6 April 2007 and 5 April 2012. More recent gains should be disclosed as normal under self-assessment. But earlier gains of up to 20 years old are disclosable if they were not declared deliberately.

However, there is a catch. HMRC must also be informed of any other undeclared income or gains, including any income from the property in question. There may be interest and penalties payable, and the campaign does not offer any special penalty mitigation.

After 6 September 2013, HMRC will use the information it holds on property sales to identify people who have not paid the correct amount of capital gains tax. The penalties will be higher than they would have been under voluntary disclosure.

Affluent Compliance Team widens aim

HMRC has been expanding its Affluent Compliance Team, the unit dedicated to ensuring that better-off people meet their tax obligations. The team started work in 2011, and has so far brought in an impressive amount of additional tax.

The original target group of taxpayers consisted of individuals who pay the top rate of income tax and have wealth of between £2.5 million and £20 million. The lower wealth limit has now been brought down to £1 million.

A sign of HMRC's increasingly pro-active approach to tax avoidance is the pre-emptive strike against one particular avoidance scheme. Letters were sent to people who had signed up for the scheme, even though no legal challenge had yet been made against it, which is the normal approach. People who receive these letters have the choice of pulling out of the scheme or being treated by HMRC as a higher risk customer and having their tax affairs more closely monitored in the future.

Helpful IHT change for non-domiciles

The exempt amount that a UK-domiciled individual can transfer to their non-domiciled spouse or partner free of inheritance tax (IHT) has increased to £325,000 – the same level as the nil rate band – from 6 April 2013.

Transfers between spouses and between civil partners are exempt from IHT, either during their lifetimes or at death. But until now, where one spouse/partner is not UK domiciled, the exemption has been restricted to a paltry lifetime limit of £55,000. In future, the exemption will be linked to the level of the nil rate band.

That's straightforward enough, but as of 6 April 2013 it is now also possible for someone who is domiciled outside of the UK, but with a UK domiciled spouse/partner, to elect to be treated as UK domiciled for IHT.

For example, Mike is UK domiciled and has assets of £2 million; his wife Sophie is non-UK domiciled and has assets of £600,000, of which £450,000 is situated overseas. After making the election, the whole of Mike's £2 million estate can pass to Sophie, although she is non-UK domiciled, free of IHT. However, the downside is that Sophie's £450,000 in overseas assets will be brought within the scope of IHT.

It is possible to make an election any time after marriage or registration of a civil partnership, and the latest possible date is two years following the death of the UK domiciled spouse/partner – provided they died after 5 April 2013.

An election can be backdated for up to seven years (but not earlier than 6 April 2013), so that any lifetime transfers during that period are covered. If the election is made following the spouse's or partner's death, it is treated as being made immediately before the death.

An election is irrevocable, but it will cease to have effect if that person becomes resident outside the UK for four consecutive tax years. Whether to make an election will need careful consideration, so please contact us if you need advice.

Hopes for holiday lets businesses just castles in the air

Tax reforms have not been kind to owners of furnished holiday property in recent years. Tax relief for losses was restricted in 2011, and the qualifying conditions for the remaining tax benefits were tightened up the following year.

Now an Upper Tribunal (Tax and Chancery) decision has dashed hopes of most furnished holiday homes qualifying for inheritance tax (IHT) business property relief (BPR). The decision in *HM Revenue & Customs v Pawson* overturns a First-tier Tax Tribunal decision from 2011. The original decision would have meant that BPR was available despite only minimal services being provided.

BPR is available in respect of a property business, but not where it consists wholly or mainly of making or holding investments. The Upper Tribunal decided that where the principal business activity involves deriving income from the occupation of land, then the starting point must be that the business is mainly one of investment. Only at the upper end of the spectrum of possible letting businesses will the extent of services provided be more significant than the investment aspect.

The property in question in the *Pawson* case was a typical holiday letting, but the services provided – just cleaning between lettings and a gardener – were fewer than offered by most holiday lets. Despite this, the decision is likely to mean that very few holiday lettings now qualify for BPR.

The question is, just what level of service is required to override the assumption that holiday letting is an investment business? HMRC currently accepts that a bed and breakfast establishment or a hotel will usually qualify for relief on the basis of the level of services provided, but is there really that much difference? Some holiday lettings provide a breakfast service, and in a hotel this might be just on a self-service basis. For now, however, it's bad news for owners of holiday lettings.

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