CLIENT BULLETIN

April 2008

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HUSBAND-AND-WIFE BUSINESSES

As you may recall, last July the long-running *Arctic Systems* case was brought to a final conclusion by the House of Lords deciding that, where husband and wife are shareholders in a family company, each is taxable on the dividends he or she receives, even if one spouse does most or all of the work which earns the company's profits. In *Arctic Systems* itself, husband and wife were equal shareholders in a company, through which the husband conducted his full-time business as a freelance computer programmer. The wife's input was limited to part-time administration and support. The Revenue claimed that all the dividends, whether paid to the husband or the wife, should be taxed as the husband's income, because he had earned the money, but the House of Lords rejected this argument. The real point at issue, of course, was that splitting the dividends between husband and wife meant they were all taxed at the basic rate, whereas allocating them all to the husband would have created a higher rate liability.

The Government immediately announced that the Finance Act 2008 would include legislation, effective from 6 April 2008, to reverse the House of Lords decision. A draft of the proposed legislation was published in December, which gave a name to arrangements which allow money earned by one spouse to be split, for tax purposes, between both: it called them 'income shifting'. It was designed to cover not only family companies, but also business partnerships between family members.

The basic principle of the proposed legislation was that where, as in *Arctic Systems*, the spouse who actually earns the money sets up or agrees to arrangements which 'shift' part of the profits to the other, those arrangements should be effective for tax purposes only to

the extent to which the 'shifted profits' represent a reasonable rate of reward for the recipient's contribution to the business. That input might be by way of working in the business, or providing capital, or guaranteeing the business overdraft.

The more or less universal reaction to the proposed 'income shifting' legislation was that it would be completely unworkable. Under self-assessment, people must put precise figures on their Tax Returns, but there could be endless argument and debate about what somebody's contribution to a business is 'worth'. For example, the Revenue view is that there will be a local 'going rate' for people employed to carry out basic secretarial and office administration work – to which the trader would reply that, in a family business context, the 'support spouse' is likely to be carrying out a wider, and more responsible, range of duties, so there is no true comparison with a secretary or administrator employed by a large organisation. At the end of the day, it is all very subjective.

Even worse is attempting to value a financial contribution. For example, suppose husband and wife jointly own their home, but the wife allows it to be charged as security for the husband's business overdraft. What is the value, to the business, of the guarantee she has given? The Revenue says that it is the difference between the Bank's rates for secured and unsecured lending, but that is unsustainable if the Bank would not have lent at all unless security had been given. The guarantee cannot have an 'open market value' because, outside a family or other close relationship, people simply don't guarantee each other's loans.

As part of last month's Budget, the Chancellor of the Exchequer announced that, although the Government still intends to press ahead with the 'income shifting' legislation, it now accepts that 'a further period of consultation' is required 'to provide clarity and certainty for businesses and their advisors'. Accordingly, implementation has been postponed for one year, until 6 April 2009. Presumably, there will shortly be another consultation paper, explaining how the Government intends to make the penguin fly.

Meanwhile, for 2008/09 the House of Lords decision remains in force and family companies can, with confidence, continue to split their dividends equally between husband and wife.

CAPITAL ALLOWANCES

We should remind all business clients that new rules for capital allowances, originally announced in last year's Budget, come into force this month (April). Most importantly, there is a new 'Annual Investment Allowance' which will allow traders to claim 100 per cent first-year allowances for most purchases of machinery, equipment and vehicles, to a ceiling of £50,000 a year. As usual, the principal exception is motor cars.

The new 'AIA' is available for purchases on and after 1 April 2008 for companies and 6 April 2008 for sole traders and partnerships. However, it is essential to note that this does **not** mean that every trader can immediately purchase £50,000-worth of new equipment that will qualify for the 100% allowance. This is because, where the trader's accounting year spans 1 April or 6 April, the allowance for that year is reduced proportionately. For example, if a company's accounting date is 30 June, the ceiling on expenditure in the

three months 1 April to 30 June, which will qualify for the 100% AIA, will be (3/12 × £50,000 =) £12,500. This was explained in greater detail in our last newsletter (December 2007), but please contact us for individual advice on how the new rules will affect you.

It is not necessary to claim the full 100%, for example if you have insufficient profits to cover the allowance, but the balance carried forward will qualify for writing-down allowances only at the new, lower, rate of 20% a year (hitherto 25%).

CAPITAL GAINS TAX

The Chancellor of the Exchequer announced, in his Pre-Budget Statement last October, that from 6 April 2008 the capital gains tax taper relief would be abolished and, instead, all capital gains in excess of the annual exemption (£9,600 for 2008/09) would be taxed at a flat rate of 18%, irrespective of whether the vendor was a basic rate or a higher rate taxpayer. There was an outcry because the Chancellor's proposals made no special provision for business assets. With full taper relief, the maximum rate of capital gains tax on qualifying business assets was 10%, so the new 18% flat rate represented an increase of 80%.

Eventually, the Chancellor relented and announced an 'Entrepreneurs' Relief'. This will charge the first £1 million of gains on business assets at 10% instead of 18%. The £1 million ceiling will apply cumulatively to gains on disposals in 2008/09 and future years of assessment. So far, that's good news, and the even better news is that each individual will be entitled to his or her own £1 million allowance, so a husband-and-wife team, if they arrange their affairs correctly, will pay 10% tax on the first £2 million of gains arising when they sell their business.

The bad news is that 'business assets' are defined differently for the new Entrepreneurs' Relief than for the old Business Asset Taper Relief. The new legislation is horribly complicated, so that any brief summary would be misleading, but the bottom line is that many sales that would have qualified for Business Asset Taper Relief will not qualify for the new Entrepreneurs' Relief. To take three examples:

- Entrepreneurs' Relief is available only where the whole business, or a distinct part of the business, is sold. It is not available where the trader simply sells a business asset. For example, it would not apply where a farmer sells a few acres of land, but carries on farming as usual on the remainder of his holding. Nor will it be available where a trader sells his workshop so that he can move to larger or better premises. (On the other hand, if the proceeds are used to buy replacement business assets – alternative farmland, say, or the new workshop – it may be possible to 'roll over' the gain and avoid any immediate capital gains tax payment.)
- Entrepreneurs' Relief will not be available on shares in a family trading company unless the shareholder owns at least 5% of the shares **and** is a director or employee of the company.
- Entrepreneurs' Relief will not be available where a shareholder-director owns the company's trading premises outside the company and charges the

company an open market rent for occupying them (or a partner owns the partnership's business premises). Relief will be restricted proportionately where a reduced rent is charged.

We would advise all clients with substantial business assets to review their ownership structures in the light of the new legislation, and in the light of their own plans for the future. Some rearrangement now may produce worthwhile tax savings when the business is sold.

INVESTMENT BONDS

The introduction of the 18% flat rate of capital gains tax will make the investment bonds sold by life assurance companies a less attractive investment, especially for higher-rate taxpayers.

Such 'investment bonds' are technically single-premium life assurance policies and the investment return comes from the income and capital gains arising on the funds managed by the life assurance company. The life assurance company pays tax at basic rate and, broadly speaking, when an investor takes a withdrawal, he pays the difference between basic and higher rate, if he is a higher rate taxpayer.

The problem with investment bonds always was that the investor could not set his capital gains tax annual allowance against gains arising within the bond. Now, a higher rate taxpayer will also be paying tax at 40% on gains arising within the bond, whereas he would pay only 18% on investments hold personally. This is a major distortion, but the Government expressly said in the Budget Report that they do not intend to correct it.

VALUE ADDED TAX

On 1 April 2008 the turnover threshold for compulsory VAT registration rose to £67,000 – this may be helpful for small traders who deliberately keep their turnover below the threshold.

Traders already registered, and who are subject to scale charges for the private use of road fuel on which input tax has been reclaimed, should note that a new table of scale charges applies from their first prescribed accounting period beginning on or after 1 May 2008. For almost all cars, the scale charge will increase – the sole exception being cars with a CO_2 emission rating of 120 g/km or less. The new table is available from HM Revenue & Customs National Advice Service (0845 010 9000) or ourselves.

Traders already registered should also note that, with effect from 1 July 2008, the rules for notifying errors on past VAT Returns will be relaxed. At present, where the net under- or overpayment does not exceed £2,000, it may be corrected on the VAT Return for the period in which the mistake is discovered. If it is larger, it must be reported on Form VAT 652 or by letter. Apart from the convenience of simply correcting an earlier error on the current VAT Return, it is also HMRC's practice not to charge interest on an underpayment of £2,000 or less.

From July, this threshold is to be increased to £10,000 (or if more, 1% of turnover for the return period, capped at £50,000). This will apply from the trader's first return period beginning on or after 1 July 2008.

This newsletter deals with a number of topics which, it is hoped, will be of general interest to clients. However, in the space available it is impossible to mention all the points which may be relevant in individual cases, so please contact us for personal advice on your own affairs.