CLIENT BULLETIN

August 2006

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DON'T PANIC !

HM Revenue and Customs are sending out a new wave of letters to small business proprietors. They are designed to test new ways of ensuring that traders are keeping proper business records and declaring all their profits. Because this is a pilot project, the letters vary considerably, but they are likely to ask the trader:

- To allow Tax Inspectors to visit the trader's premises to examine his or her cash handling and accounting procedures and the books (or computer records) for the current year.
- To complete a questionnaire – questionnaires are being compiled for trade sectors where HMRC suspects under-reporting of profits is commonplace.
- To 'self-audit' by reconsidering specific entries on his or her last Tax Return (a development of the notorious 'enabling letters', which suggested that trade expenses had been overstated).
- To read a list of errors and false statements found in Returns submitted by other people carrying on a similar trade and to confirm that his or her own Return does not need correction.
- To respond to a 'challenge' – where HMRC will state that they have specific information that a particular figure on the trader's Return is incorrect. An

example might be a relatively small discrepancy between the contractor's and the subcontractor's record of payments made.

It should be noted that the only relevant statutory powers HMRC have are to examine the trader's payroll, Construction Industry Scheme and VAT records – otherwise, they cannot insist on his or her co-operation. The unspoken threat is, however, that if the trader does not co-operate, HMRC may open a formal Enquiry.

Two points cause us great concern. The first is that HMRC originally proposed to write to traders without sending a copy to their accountants. Although they have now relented, past experience warns us that HMRC's system for sending copies is unlikely to be 100% reliable, so please contact us immediately if you receive such a letter. The second is that HMRC also intend to telephone traders with their requests and queries. We very strongly recommend that you make a careful note of the requests made and questions asked, say that you cannot sensibly answer them 'off the top of your head', and again contact us immediately. (Also, bear in mind that anyone seeking information may not really be calling from HMRC.)

If you do receive a letter, or a telephone call, don't worry. HMRC are not writing or calling because they have any real reason to believe your last Tax Return was inaccurate. They are targeting you because you are a cash trader, or because their computer considers your figures to be 'outside the norm', or because of 'guilt by association' – they have found that other people carrying on similar trades have been cheating on their taxes, so they assume you have too.

INHERITANCE TAX

The reform of the inheritance tax treatment of family trusts, announced in the Budget, was severely criticised, not only by accountants and lawyers, but also by financial commentators in the newspapers and elsewhere. In response, the Government has made a number of changes of detail to the original proposals, but the main structure of the new scheme remains unchanged. All the argument has left most people thoroughly confused as to what the current position actually is, so the main article in this newsletter seeks to answer some 'frequently asked questions':

Do I need to make a new Will?

Lawyers estimate that around half of existing Wills may not achieve the best inheritance tax result under the new régime. The most common problem is likely to affect trusts set up by Will for the benefit of the testator's children. Under the old rules, favourable treatment applied provided the beneficiary became entitled to the *income* generated by the trust no later than age 25. Under the new rules (in their final form), to qualify for favourable treatment, the beneficiary must become entitled to the *capital* outright by that age. (This vitally important point would be easy to overlook, as it has largely been overshadowed by the argument as to whether the qualifying age should be 18 or 25.)

A difficulty when reading a Will (or any document setting up a trust) is that the trustees often have statutory powers, which are not set out in the document itself, but which may affect the tax position. The Government itself overlooked this point when drafting the original legislation for this year's Finance Bill. Do not assume, therefore, that the Will actually means what it says.

Because circumstances change, it is anyway good practice to review your Will at least every five years: if a further prompt is needed, the new legislation certainly provides it.

Do I need to review my existing life assurance policies?

Life assurance policies are often written in trust, either to protect the beneficiary from creditors or with a view to reducing inheritance tax liabilities. In its final form, the new legislation makes it clear that a policy taken out before Budget Day will continue to be subject to the old inheritance tax rules, even if premiums continue to be paid after Budget Day. However, this protection can be lost if substantial changes are made to the policy: the life assurance company should be able to advise whether a proposed change will trigger what is technically called 'loss of transitional protection'.

A related point is that it may be possible, under the terms of the policy trust, to appoint new or additional beneficiaries. Generally speaking, the legislation allows a 'window of opportunity', which closes on 5 April 2008, to do this in a tax-efficient way. Accordingly, policyholders should, before that date, consider whether the policy trusts still fully reflect their wishes.

Are new tax-efficient life assurance policies still available?

A more limited range of life assurance based inheritance tax plans remains available. However, whereas in the past 'flexible' plans have traditionally been the most popular, for the future the most tax-efficient will require the investor to make an irrevocable choice of beneficiary(ies) at the outset.

Is there still any scope for making lifetime settlements?

Surprisingly, despite all the bad publicity, the answer is: 'Yes'. And in many cases, a lifetime settlement will actually be more attractive than before.

To start with the bad news, most settlements made by living people will now be subject to an immediate inheritance tax charge, calculated as 20% of the value of the property settled. But the exceptions will be:

- Where the property settled falls within the settlor's nil rate band (currently £285,000). Strictly speaking, tax is chargeable at nil per cent, which (as will be explained below) has important consequences.
- Some (not all) trusts set up as part of a divorce settlement.
- Trusts for the benefit of a seriously disabled person.

Additionally, all lifetime trusts, except those for the benefit of a seriously disabled person, are potentially liable to an inheritance tax charge every ten years (a maximum of 6% of the value of the trust property) and when any property leaves the settlement.

However, the good news is that the new rules may reduce the capital gains tax payable on transferring assets to a settlement. Broadly put, the gift of investments to a settlement counts as a disposal for capital gains tax purposes, but if the transfer is subject to inheritance tax, then the gain may be ‘held over’ until the investments are eventually sold by the trustees. This applies even if no inheritance tax is actually payable because the settlement falls within the settlor’s nil rate band.

Paradoxically, therefore, the new legislation may actually help someone wishing to set up a relatively small trust for his or her family, using existing investments.

Does the ‘seven year rule’ still apply for lifetime gifts?

The rule remains that a lifetime gift is written off the donor’s inheritance tax ‘clock’ after seven years – so that if an individual survives for seven years after making a gift, his full nil rate band will be available to set against his estate on death. This point was not clear from the original Budget Day announcement, which led to further confusion.

What can we do if someone died recently?

Here the problem is likely to be that the Will was written with the pre-Budget legislation in mind and so does not achieve the optimum tax result under the new law.

Some modern Wills set up a ‘discretionary Will Trust’ which effectively allows the executors to rewrite the Will within two years of the testator’s death. Otherwise, it may be possible for the beneficiaries and potential beneficiaries to rewrite the Will by means of a Family Arrangement – this is also possible where the deceased died intestate, but in either case is more complicated where the original beneficiaries include children (who are in law incapable of giving their consent). Again, the time limit is two years from the testator’s death.

..... or less recently?

However long ago the testator died, the trustees of an existing Will Trust have until 5 April 2008 to rearrange matters to achieve a more favourable inheritance tax outcome. The same applies where the trust was originally set up by a living person.

What can be done will depend on the circumstances of the case, including the trustees’ powers under the Will or the general law, but most commonly it will involve either ensuring that the beneficiary becomes entitled to the capital by age 25 or arranging for the current life tenant to surrender his or her interest (which in some circumstances may provide an inheritance tax free transfer to the next generation). In either case, expert legal advice will be required and it will be necessary to consider the capital gains tax, as well as the inheritance tax, implications of any proposed arrangement.

SALES ON INTERNET AUCTION SITES

We are sometimes asked whether sales on eBay and similar internet auction sites are subject to income tax or VAT. The answer is that the rules are exactly the same as those for more traditional methods of selling secondhand goods, such as car boot sales or classified advertisements in the local newspaper.

A sale is not a taxable transaction for income tax or VAT purposes unless the item in question was originally acquired with a view to resale, or was acquired in the course of a business. Such items will usually have been acquired by purchase, but they could have been made, grown or (in the case of animals) bred.

Thus tax will not be payable if someone simply clears out his attic or his garden shed and sells some unwanted personal possessions – or if he decides to sell the ugly Victorian china ornaments he has just inherited from his great-aunt. (The only exception is that capital gains tax may be payable if any one item, or set of items, is worth more than £6,000 or the sale is of coins which are legal tender.)

A possible 'grey area' is the collector-come-amateur-dealer – for example, the stamp collector who purchases an auction lot, takes what he wants for his own collection, and sells on the remainder. Much will depend on whether he makes a regular profit.

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.