CLIENT BULLETIN

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A G Kelly Ltd - Accountants

A NEW FINANCE ACT

The Government has just enacted another long and very complex Finance Bill, introducing a wide range of important changes to the tax system. In this newsletter we would like to focus on two, which we think will be of particular interest to clients.

Will incorporating your business save tax?

One of the major surprises in the April Budget was the Chancellor's decision to reduce the 'starting rate' of corporation tax to nil per cent. However, this does not mean that every company will have a 'nil rate band': instead, a trading company with profits up to £10,000 will pay no corporation tax, but where profits exceed £10,000 a year, the benefit of the nil rate will gradually be clawed back, so that a company with profits of £50,000 or more will pay the small companies rate of 19 per cent on all its profits, including the first £10,000.

Even so, for many small traders, the nil per cent starting rate is another reason to consider incorporating their businesses. Moreover, the main tax advantage of incorporation - the ability to pay out a proportion of profits as dividends rather than salary, and so reduce or even avoid National Insurance contributions - has been made even more attractive, now that the Chancellor has warned that contribution rates will rise by one percentage point next April.

However, there are also disadvantages: most importantly, traders supplying their own services, from building industry subcontractors to computer programmers, may well find that, if they incorporate their businesses, they will be caught in the tentacles of the IR35 legislation. This effectively ignores the company and taxes the individual as if he was an employee - a case of out of the frying-pan, into the fire.

From a capital gains tax point of view, it is generally better to keep substantial business assets in personal, not company, ownership, so that they qualify for taper relief. It may be possible for a company to carry on a trade, but for the shareholders to own the trading premises personally. However, goodwill has to be owned by the legal entity carrying on the trade and in many trades, goodwill is the single most valuable asset.

A final point to bear in mind is that the tax rules may well change again, so before incorporating a business to save tax, it is sensible to consider how it could be disincorporated again if the need arises. Generally speaking, it is possible to incorporate a business without triggering significant tax liabilities, because there are special reliefs for incorporation. However, there are no parallel reliefs for disincorporation, which means that a company can become a kind of fiscal prison.

The right answer will depend very much on the circumstances of the individual case. If you are considering incorporating your business, whether for tax or commercial reasons, we do strongly recommend you to discuss the advantages and disadvantages of your various options with us, at an early stage.

Ten per cent capital gains tax on business assets - perhaps!

The Government and the Inland Revenue have really hammered home the message that the enhanced taper relief for business assets, introduced by the Finance Act, means that the maximum capital gains tax charge, on business assets sold after two years' ownership, will be ten per cent.

The low tax rate is good news, but the potential problem is that it applies only to 'business assets', as defined by the taper relief legislation. The statutory definition is very restrictive and excludes many items that would normally be thought of as 'business assets'. The main danger area is that shares in a family company do not qualify unless the company:

- Carries on a trade or trades; **and**
- Does **not** carry on any substantial non-trading activity.

The Inland Revenue's rule of thumb is that a company does not qualify if more than 20 per cent of its turnover comes from non-trading activities; or more than 20 per cent of its assets are not trading assets; or more than 20 per cent of management time is devoted to non-trading activities. To take two fictional examples:

Agricola Ltd is a farming company. Because of the foot-and-mouth outbreak and the agricultural recession, farm sales have slumped, so that the rent from old barns let out as small business units now accounts for a third of turnover. The company has breached the '20 per cent' rule and so its shares are not 'business assets' for taper relief purposes.

Midas Ltd makes gold from base metals and has, unsurprisingly, been trading profitably for many years. The shareholders are all higher-rate taxpayers and so have found it tax-efficient to retain a proportion of profits within the company. Stock exchange and other investments now account for a third of the company's assets. Midas too has breached the '20 per cent' rule and its shares are not 'business assets' for taper relief purposes.

Where the proprietors of a family company (or other privately-owned trading company) think they may wish to sell their shares at some time in the future, they should bear the '20 per cent' rule in mind. Bear in mind also that it is not enough for the shares to have qualified as business assets for the last two years before the sale - for full taper relief to be obtained, the shares must have been business assets continuously since 6 April 1998.

More generally, anyone setting up a business, or acquiring substantial business assets, should consider the holding structure carefully. We strongly recommend that they discuss alternative formats with ourselves, before committing themselves to one particular course of action.

WORKING AT HOME

Sometimes, significant changes are made to the tax rules, not by new legislation, but by the Inland Revenue and other Government agencies reconsidering their interpretation of existing laws, or by focusing their attention on particular areas. A change in practice can be a very quiet way of introducing a new 'stealth tax' and a current example is the imposition of business rates on people who work from home.

Working from home, in one form or another, has always been popular, but until recently it was rare for the authorities to claim that, where a householder used a room for business purposes, a liability to business rates arose.

The law and the practice

In principle, the Council Tax is charged on houses and flats and business rates are charged on business premises. Dual-use buildings - for example, a shop with living accommodation - may be charged partly to Council Tax and partly to business rates.

Council Tax and business rate assessments are made by the Valuation Office Agency - a branch of the Inland Revenue - although the tax is collected by local authorities. Recently, the Agency has become more aggressive in its approach to people who work from home and is now more likely to argue, for example, that a householder who uses a room as an office should pay business rates on that room.

When will business rates be claimed?

The first, and most important point, is that a room may be liable to business rates even if it is not used wholly for business purposes. For example, a room that is generally used as an office may be liable to business rates, even if it is occasionally used for domestic purposes - say, as a guest bedroom.

Secondly, a room that has been specially created as working space (for example, converted from an integral garage) may be liable to business rates, even if there is significant private use.

Thirdly, a 'home office' may be liable to business rates even if the householder is not himself in business - for example, if he is a full-time employee of a major public company who is required, or allowed, to work from home. Business rates apply to any non-domestic use, and so may also be due if the householder works for a public sector body or a not-for-profit organisation.

Fourthly, the Agency has specifically said that it will charge business rates, even if the reason the householder works from home is that he is disabled.

Finally, the Valuation Office Agency's attack is directed not only at 'home offices' but at every kind of home-based business activity - for example, music teachers, health practitioners who see clients at home and market traders who need somewhere to store their merchandise.

How can the householder defend himself?

If possible, try to ensure that no room is used predominantly for business purposes, that there are no physical alterations to the building, and that there is no external indication that the house is used for business purposes. (The Valuation Office Agency considers, for example, that a doctor's 'brass plate' by the front door is evidence that the house is used for business purposes.)

Before imposing business rates, the Agency will send someone to inspect the premises, so it is important that the room looks like an ordinary room used by the family.

More generally, the whole question of business rates for working at home is a very grey area. The legislation does not clearly define the point at which business use of a house or flat creates a liability to business rates and it is at least arguable that the Valuation Office Agency's current, aggressive stance runs counter to assurances given by the Government when the Local Government Finance Act was debated in Parliament.

On the other hand, though its general principles are hazy, the legislation does set out some complex detailed rules - for example, that a domestic garage does not attract business rates, even if it is used for a business purpose (such as garaging a van or taxi, or storing merchandise), provided its floor area does not exceed 25 square metres. There are also special rules for guest houses and bed-and-breakfast accommodation.

All this means that, if the Valuation Office Agency indicates that they are considering imposing business rates liability, you should seek specialist advice, probably from a Chartered Surveyor specialising in rating work. The mere fact that you are professionally represented will make the Agency realise that you are not to be steamrollered into accepting liability in a marginal case and the surveyor will know how to counter the Agency's often partisan arguments.

. . . . . AND FINALLY

We would like to close with a message for members of your family, especially those who have retired, who have simple financial affairs and who do not have accountants of their own. The message is: **Don't trust the Inland Revenue to get it right.**

The PAYE system has never been very good at coping with people with more than one source of income and if someone has, say, a National Insurance Retirement Pension, an Armed Forces pension and a pension from a former employer, it is frankly unlikely that the total tax deducted will exactly match their true liability for the year. Particular problems arise when pensions or allowances begin or end during the tax year, or are increased or reduced. Accordingly, it is always worth checking, at the end of the tax year, to ensure that excessive tax deductions have not been taken.

A related point arises where someone has a small pension, which does not use up all his tax allowances, and investment or trust income, from which tax has been deducted. In past years, the Inland Revenue would have issued a Tax Return and invited the pensioner to claim a repayment; now, however, there appears to be a growing practice of not issuing a Return unless the individual himself writes in to claim a repayment. (More helpfully, in straightforward cases, if the letter lists the individual's full income for the year, the Revenue will usually make the repayment without requiring him to complete a formal Tax Return, but the main point remains - it is up to the individual to claim the repayment to which he is entitled.)