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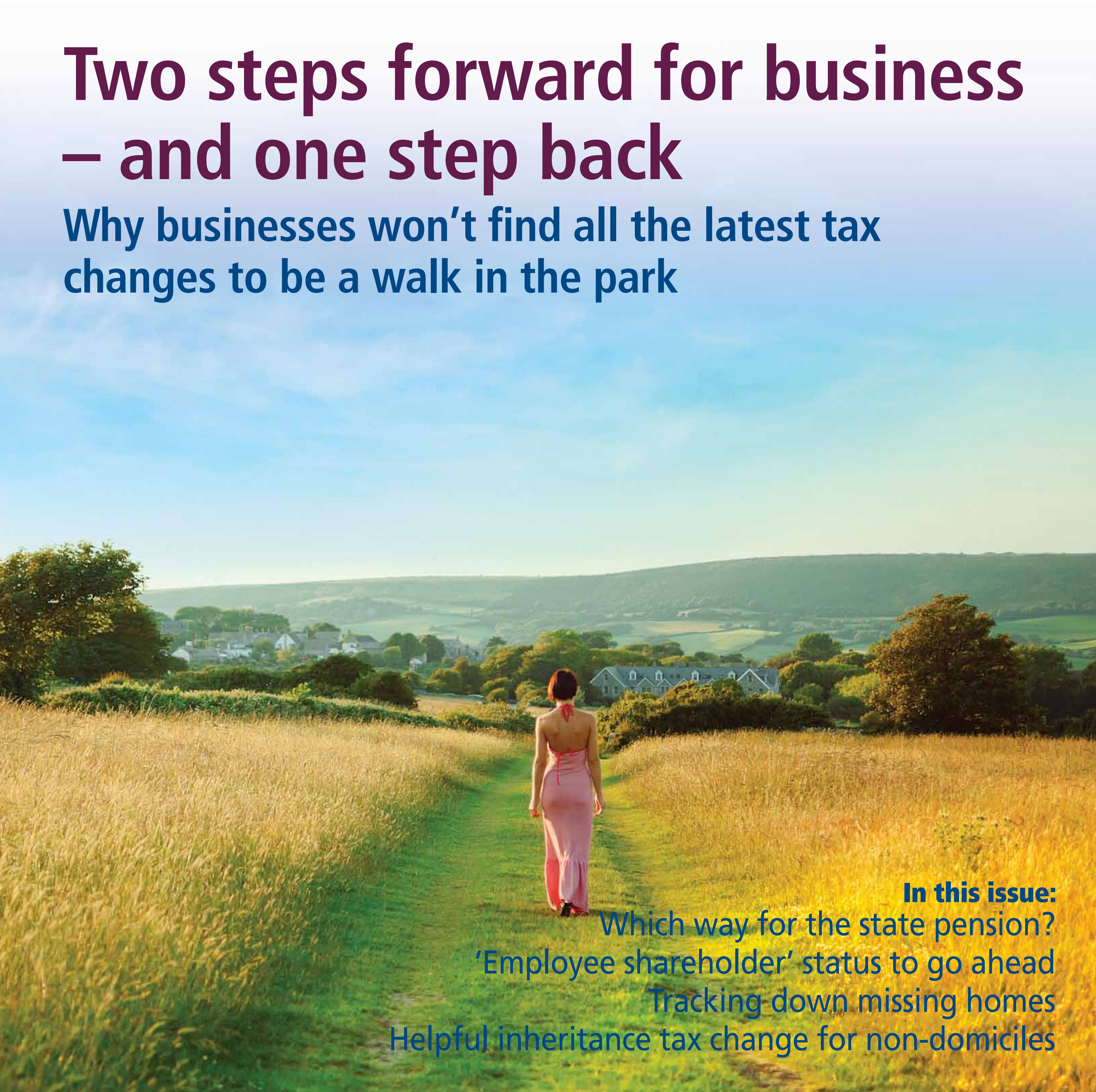
financial UPDATE



Two steps forward for business – and one step back

Why businesses won't find all the latest tax changes to be a walk in the park

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Hopes for holiday letting 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 income tax and capital gains tax (CGT) 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 the 2011 First-tier Tribunal decision.

HMRC previously accepted that BPR was normally available where lettings were short term and the owner, or their agent, was substantially involved with the provision of services. But this changed to a stricter interpretation a few years ago, with the emphasis on the level and type of services rather than who provided them. The original First-tier decision would have meant that relief was available despite only minimal services being provided – so virtually all furnished holiday homes would have qualified.

BPR is available in respect of a property business, but not where it is wholly or mainly an investment business. The Upper Tribunal decided that where the principal business activity involves taking 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 the services provided be more significant than the investment aspect. The Upper Tribunal also took the view that a property should not receive special treatment just because it qualifies as a furnished holiday letting.

The property in question in the *Pawson* case was a typical holiday let; it was fully furnished and let for long weekends or for one or two weeks at a time. But the services provided were fewer – just cleaning between lettings and the services of a gardener – than those offered by most holiday lettings. Despite this, the decision is likely to mean that very few holiday lettings now qualify for BPR. Lettings will be treated the same as other property and will be subject to 40% IHT.

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 just be on a self-service basis. For now, however, it's bad news for owners of holiday lettings.

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 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 second state 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.

The single-tier state pension 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 and you will have to qualify in your own right. Your single-tier pension will be proportionately reduced if you do not have enough qualifying years by the time you have reached your SPA. 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 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.' Depending on your foundation amount, you will fall into one of four categories.

People with a foundation amount equal to the full single-tier pension – likely to be people who have the necessary 35 qualifying years, little additional state pension and have not been contracted out of S2P/SERPS. The long term self-employed could fall into this category.

People who have a foundation amount below the full single-tier pension – likely to be younger people with fewer qualifying years, or older people who have spent many years contracted-out of S2P/SERPS. They will be able to build up entitlement to the full single-tier pension.

People with a foundation amount above the full single-tier pension – likely to be older people with many qualifying years who have not been contracted out. They will receive their foundation amount, inflation adjusted, but not accrue any further state pension under the new system.

People with no pre-implementation national insurance record – these people will have to build up all their entitlement 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 rate of NICs once the single-tier pension is introduced.

Seed investment scheme extended

The seed enterprise investment scheme (SEIS), introduced last tax year, offered 50% income tax relief and a complete capital gains tax (CGT) exemption for reinvested gains. You can still invest for 2012/13, because the investment deadline is 5 April 2014. For 2013/14 there is no change to the income tax relief and the CGT exemption has been extended for another year. However, this year only 50% of reinvested gains will be exempt. So if you make the maximum investment of £100,000, you can benefit from £50,000 of income tax relief and exemption for a possible £50,000 of gains – but only if you make gains of at least £100,000 during 2013/14.

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 around 21%, 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.

In the light of these changes, larger companies should consider bringing forward their planned revenue and capital expenditure to reduce their profits that would be subject to the current higher rates. In the longer term, a unified rate will vastly simplify the planning of group structures, especially for medium-size businesses – currently, the £300,000 and £1.5 million profit limits are shared equally between all group companies.

The second bit of good news announced in the Budget will particularly benefit smaller businesses. This is the announcement of an annual £2,000 employment allowance which, from April 2014, all businesses will be able to set off against their employer national insurance contributions (NICs) bill. Employers will be able to claim the allowance as part of the normal payroll process under Real Time Information (RTI) reporting, and it will effectively be a £2,000 nil rate NICs band. Employee contributions will remain payable as normal. 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.

“...a unified rate will vastly simplify the planning of group structures, especially for medium-sized businesses...”

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. A significant cost will still be attached to the salary option, although it does avoid the nasty shock of a self-assessment tax bill following the end of the tax year. The difference will completely vanish for those over state pension age who do not pay employee NICs.

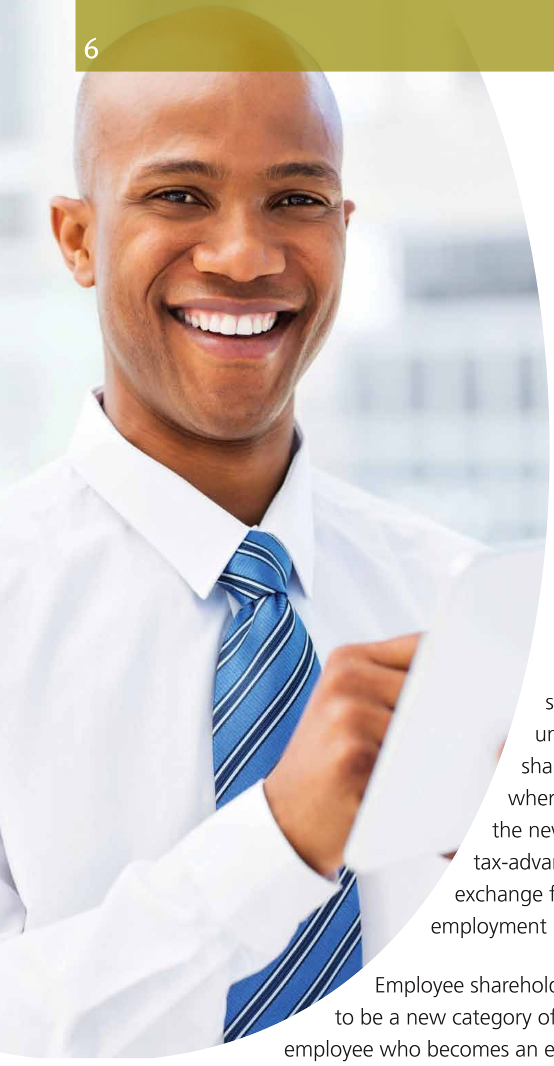
The decision to incorporate will depend on the level of profits, and how those profits are withdrawn after incorporation. With a profit level of £40,000, a self-employed person would have a total tax and NICs bill of a little more than £9,000. The bill would currently be just over £10,000 if the business 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 for these reliefs is 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. For example, it has been common for business owners to borrow funds personally and then lend them on to their companies. It may be necessary to change these types of arrangements so that companies and other entities borrow funds directly rather than through their individual owners. Please contact us if you think you may be affected.

Boost for AIM shares

Alternative investment market (AIM) shares already receive preferential tax treatment – an exemption from inheritance tax if held for two years – but their status should be further enhanced next year. From April 2014, no stamp duties will be payable when buying shares listed on the AIM (the rate is currently 0.5%). The Government is also consulting on permitting the inclusion of AIM shares within stocks and shares ISAs for the first time, possibly from 2014/15. However, various other tax reliefs are available where AIM shares qualify under the enterprise investment scheme or seed enterprise investment scheme, and these may be lost on such investments made through an ISA.



'Employee shareholder' status to go ahead

The controversial concept of a new employment status, that of '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' arrangement, whereby those adopting the new 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's 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 initial share allocation is free of tax and national insurance contributions (NICs). This effectively allows an employee shareholder to receive the minimum allotment free. If the shares allotted are worth more than £2,000, the excess is treated as earnings and subject to tax and NICs as for other payments of earnings. The amount charged to tax is based on the market value of the shares when they were allotted and corporation tax relief is available to the employer for their cost.

The shares will also benefit from a capital gains tax (CGT) exemption. Any gain by an employee shareholder on the disposal of up to £50,000 worth of these shares will be exempt from CGT.

The tax advantages are subject to meeting a number of conditions and there are various anti-avoidance measures to prevent exploitation. The shares themselves come at a price to the employee.

The legislation creating the new employee shareholder status was introduced in the Growth and Infrastructure Bill, which has had a rocky passage through Parliament. The rights forfeited are considered by many commentators to be fundamental and it is this aspect that has proved to be the most 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 intended start date for the new employee status is 1 September 2013, as announced in the 2013 Budget. This is dependent on the necessary legislation making it to the statute books, however.

PAYE reporting – Real Time easing

Real Time Information (RTI) reporting is now a fact of life for most employers, but a recent relaxation of reporting requirements might help some small businesses struggling with the increased frequency of PAYE filings.

Be warned that this is not a withdrawal of the reporting requirements and reporting in real time was still required from the first payday on or after 6 April 2013.

The relaxation applies to businesses with fewer than 50 employees and it can only be used until 5 October 2013. Such businesses will be permitted to file on a monthly basis, even if their employees are paid more frequently – such as weekly or fortnightly. Information must be sent to HMRC by the last payday in the month, but no later than the end of the tax month (a tax month always ends on the 5th of a calendar month).

HMRC has said that it will continue to work with employer representatives to assess the impact of RTI on smaller businesses and will consider whether there is scope for further improvements.

But you should assume that the full reporting requirements will apply from 6 October 2013; so small businesses are advised to use the extra time to adapt their processes and ensure that they can report their PAYE position each time employees are paid.

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 on 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 period covered by the campaign is primarily gains 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 can be disclosed 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 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. There are several tax aspects of property disposals that can trip up the unwary.

What is the 'cost' of the property? Gain is essentially sale proceeds less cost. Mostly, 'cost' is what the owner paid for the property plus fees and various other allowable expenses. In some cases, 'cost' is the property's market value when it was acquired, for example if it was inherited, received as a gift or bought for less than its full value from a close relative. Where the owner received the property from a spouse or civil partner, it is the original cost that is relevant – not the value at the time of the gift. For properties acquired before 31 March 1982, the market value at that date – rather than the cost – is used.

What are 'proceeds'? Normally the proceeds are easy to ascertain. But market value is used if the property has been gifted or sold for less than its full value to a close relative. A disposal to a spouse or civil partner is normally ignored.

Enhancement expenditure The gain can be reduced by expenditure that has enhanced the property's value – such as an extension – but not by normal maintenance costs, such as repairs or decorating.

Periods when a main residence has been unoccupied A period when a property has not been occupied can mean that it is not fully exempt, but some of these periods can be ignored – in particular, the final 36 months of ownership. There is also an exemption for some periods of letting.

You should also note that HMRC's Affluent Compliance Team has recently been expanded, and it targets those people who have a low effective rate of tax across their total income, late self-assessment filers and those with property portfolios. Please contact us for more information.

> "After 6 September 2013, HMRC will use the information it holds to identify people who have not paid the correct amount of CGT."

Trusts for the disabled

Trusts for the disabled benefit from a tax privileged status, but there has been concern that disabled people could lose out following the abolition of the disability living allowance – a key qualifying condition. The initial proposal was that only those who were receiving the enhanced rate of the daily living component of the new personal independent payment would qualify. This would have been a severe restriction, but the definition for trust beneficiaries has been extended to include those receiving the standard rate. Those who receive the armed forces independent payment are also now included, but it is disappointing that the Government has ducked the opportunity to simplify the complex vulnerable trust legislation.

Helpful inheritance tax 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 lifetime 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. In addition there is the £325,000 nil rate band; so the total amount that can left free of IHT to a non-domiciled spouse or partner can be as much as £625,000.

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 worth are 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 the 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.

Tax calendar 2013

Every month

1 Annual corporation tax due for companies with year ending nine months and a day previously, e.g. tax due 1 January 2013 for year ending 31 March 2012.

14 Quarterly instalment of corporation tax due for large companies (depending on accounting year end).

19 Pay PAYE/NIC and CIS deductions for period ending 5th of the month if not paying electronically. Submit CIS contractors' monthly return.

22 PAYE/NIC and CIS deductions paid electronically should have cleared into HMRC bank account.

30/31 Submit CT600 for year ending 12 months previously. Last day to amend CT600 for year ending 24 months previously.

File accounts with Companies House for private companies with year ending nine months previously and for public companies with year ending six months previously.

If the date for payment falls on a weekend or bank holiday, payment must be made by the previous working day.

May 2013

19 File 2012/13 annual PAYE return online. Penalties are charged if forms are late.

31 Last day to issue 2012/13 P60s to employees.

July 2013

5 Last date to agree a 2012/13 PAYE Settlement Agreement (PSA) with HMRC.

6 Deadline for employers to make returns of expenses and benefits (forms P11D, P9D and P11D(b)) for 2012/13 to HMRC and provide copies to employees.

14 Due date for CT61 return for quarter to 30 June 2013.

31 Confirm tax credit claims for 2012/13 and renewal for 2013/14.

Due date for second self-assessment payment on account for 2012/13.

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