GENIE

NEWS, INFORMATION & EVENTS

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GERALD EDELMAN • CHARTERED ACCOUNTANTS • BUSINESS ADVISERS • TAX CONSULTANTS

HUSBAND & WIFE COMPANIES UNDER ATTACK

Many clients will have seen in the financial press publicity surrounding a large tax demand issued to an IT contractor who had issued shares in his "one-man company" to his wife. Ostensibly, the purpose for doing this was to divert income to his wife who had no other income and thus he could avoid higher rate tax on some of his income, whilst his wife could use up her lower rate tax bands. Overall, the family unit was somewhat better off.

The Inland Revenue have dug-up some old legislation relating to settlements to try to counteract the planning arrangements. These provisions are found in Section 660 of the Taxes Act 1988. These state that the income arising from a settlement, where the settlor retains an interest, is taxable as income of the settlor, and he is deemed to have retained an interest if the income can be payable for the benefit of the settlor or his spouse "in any circumstances whatsoever".

However, there is a let-out for outright gifts made between husband and wife, provided that the property given is not wholly or substantially a right to income.

Many of the family planning arrangements are carried out in a very provocative way by creating a special class of shares, ie, preference shares, deferred shares etc, which are then issued to the wives who have no voting rights but just the power to receive a dividend.

It is clear that these arrangements are certainly up for review and there are likely to be a number of Court cases which will clarify what planning is actually acceptable by the Courts.

What does seem clear however is that if a husband gives his wife some ordinary shares, so that no special class of shares has been created for her, there is certainly less of an arrangement. She should be entitled to vote in general meetings and to share in the proceeds of any future winding-up. This strengthens the case considerably and provides a good defence to any Inland Revenue attack.

I will write further updates on the Section 660 attack in subsequent editions of GENIE.

There are some excellent articles in this edition of GENIE including a special feature on Tax Planning for Property Investment and Development which I hope you find of interest. As ever if there are any topics you would like covered in our Autumn edition just drop me an email to cburns@geraldedelman.com.

Colin R Burns

WHEN ARE PEPs, ISAs or TESSAs NOT TAX FREE?

Where clients have built up sizeable PEP/ISA/TESSA portfolios in certain circumstances it may well be worthwhile considering transferring the value of the portfolio into a Bond written in Trust in a way which could save a considerable amount of tax.

One might ask how is this possible? After all PEPs/ISAs/TESSAs are free of Income Tax and Capital Gains Tax and Insurance Bonds are subject to Income Tax on encashment. The answer lies in the fact that PEPs/ISAs/TESSAs cannot be assigned into Trust and are therefore potentially liable to Inheritance Tax (IHT) at 40% where they are left to a non-spouse beneficiary and the overall value of the estate exceeds the nil rate band (£255,000 for the tax year 2003/2004). Bonds, on the other hand, written in Trust, can escape IHT if the donor survives seven years from inception of the Bond and even if death occurs within seven years some arrangements will provide an immediate reduction in the donor's Estate. Whilst saving your beneficiaries IHT, these arrangements can also provide the donor with an 'income' stream without infringing the revenue's reservation of benefit provisions. The amount of the immediate reduction will depend on the age of the donor, their health and 'income' requirements.

Furthermore encashment of the Bond in the year following death will mean that Income Tax at 34% maximum will be payable on the growth of the Bond rather than on the Bond value itself.

The saving can be illustrated in the following example.

Mrs X is a widow aged 65 and has a PEP/ISA/TESSA portfolio of £100,000. It is assumed that over the next 10 years the portfolio grows to £150,000. On the death of Mrs X after 10 years, IHT will be payable of 40% of £150,000 leaving a net sum after IHT of £90,000.

Compare this with an encashment of the portfolio and reinvestment into a Bond written in Trust for beneficiaries.

	£
Bond at inception	100,000
Growth over 10 years	50,000
Bond value at death (No IHT payable)	150,000
Income Tax on £50,000 at no more than 34%	(17,000)
Net sum available for beneficiary	**133,000**
Net sum available after IHT on PEP/ISA/TESSA portfolio	**90,000**
Saving to Estate	**43,000**

If you would like to discuss the ramifications of this Tax planning opportunity on your estate, please contact Nigel Thomas.

GENIE AT A GLANCE

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REDUNDANCY

If you are contemplating redundancy within your workforce you will need to carefully consider how it should be handled. Firstly, let us define redundancy. Current legislation states that redundancy occurs only where a dismissal is wholly or mainly because:

(a) the employer has ceased to carry on the business or intends to cease to carry on the business for the purposes of which the employee is employed;

(b) the employer has ceased, or intends to cease, to carry on that business in the place where the employee was employed;

(c) the requirements of that business for employees to carry out work of a particular kind have ceased or diminished or are expected to do so;

(d) the requirements of the business for employees to carry out work of a particular kind in the place where they were employed have ceased or diminished or are expected to do so.

So we can see that there must be a fundamental business case for dismissal through redundancy. Furthermore, the employer has a duty to take all practicable steps to avoid, or reduce the impact of redundancy. Here it is worth noting that redundancy is not a device for simply dismissing difficult employees or those with poor disciplinary records, though, of course, such employees may be dismissed in a genuine redundancy.

Having determined a legitimate basis for redundancy there are many issues you will have to address. Here are some key questions relating to common issues in redundancy:

i. have you fully explored the alternatives to redundancy?
ii. will the redundancy/redundancies be voluntary or compulsory?
iii. what is a fair and reasonable basis for selection?
iv. what notification must be given and to whom?
v. how will you manage the consultation process?
vi. what rights will employees have to appeal their dismissal?
vii. which of your employees qualify/do not qualify for statutory redundancy pay?
viii. what is redundancy pay and how is it calculated?
ix. do any of the affected employees have additional contractual rights in redundancy?
x. what information are you required to give an employee when confirming their redundancy?
xi. what impact will redundancy have on the morale of those employees not being made redundant?

You must be careful to ensure that your redundancy procedure is fair, reasonable and accords with your obligations under employment legislation. Failure to do so could give rise to claims for unfair dismissal at an Employment Tribunal.

There are, of course, many other questions relating to redundancy and one frequently asked is whether employees are entitled to pay in lieu of notice "PILON" as a tax-free payment where the employment is terminated without proper notice being given by the employer.

Generally, if the payment is due to the employee under the terms and conditions of employment or other legal entitlement, then the payment is taxable and subject to Class 1 National Insurance Contribution in full. If the employment contract does not incorporate a provision to make payment in lieu of notice and the employer fails to give the employee proper notice, particularly in a case of compulsory redundancy, it represents damages for breach of contract. Any payment is then only taxable to the extent it exceeds the current tax-free compensation limit of £30,000 and there is no NIC liability. However, even in the latter case the Inland Revenue may need to be satisfied that the payment is compensation for ending the employment rather than a contractual benefit deriving from it.

Another point to be aware of concerning notice periods in redundancy is that under the Employment Rights Act 1996 an employee who is to be made redundant has the right to paid time off work to look for another job or to arrange for training. The Act does not actually specify how much time off the employee is entitled to, but case law indicates that a maximum of two days per week would be reasonable.

Should you require advice on redundancy or other employment issues please contact Seán Lamb at our Whetstone office.

GENIE
COMPUTERS

GERALD EDELMAN COMPUTER SERVICES – *OUR NEW DIVISION*

We have noticed an ever-increasing number of clients are turning to us for advice in connection with the implementation of new or renewal programmes for both their computer systems and the accounting software. Many have done this following experiences with computer consultants who have not worked closely enough with the business and have consequently implemented either a system which is far beyond the client's requirements or a system that is not appropriate to the circumstances.

There have also been numerous examples of clients seeking our help after having been the recipients of unpleasant viruses and not having sufficient protection from these or proper data backups. The costs of these occurrences can far outweigh the cost of prevention.

We have recognised this specialist field and accordingly we are pleased to announce the formation of our specialist division GEACS Limited. The Directors of this division include our IT Partner Stuart Rosenberg, Colin Burns, Richard Kleiner, Adam Painter and Rachel Andrews who will all be in a position to focus on clients' requirements. The division will also advise clients on appropriate backup and anti-virus measures together with the day-to-day problems and management of computer systems, as required.

GEACS Limited can be contacted on our dedicated phone line 01442 241821.

Our fellow directors in this division, who will be new to you, come from a highly regarded company in this sector who have been established since 1986 and offer an exceptional level of expertise and customer service. Some of the more common services that can be provided are:

- **Sales – Hardware and Software**
- **PC and network installations**
- **Remote access solutions**
- **On-site technical support**
- **Telephone support**
- **Maintenance**
- **E-mail**
- **E-business solutions**
- **Contact management**
- **Sage line 50 accounting**
- **Sage line 100 accounting**
- **Training**

CHANGES TO YOUR PENSION PROVISION

There has been much in the press regarding the Government Green Paper issued last December setting out the Revenue's desire to reform pensions.

There were actually two papers, one issued by the Department of Work & Pensions (the true "Green Paper") and a second issued by the Inland Revenue. Many of the changes proposed, it has recently been confirmed, will be introduced from 6th April 2005 (known as A-Day).

It is the Revenue's paper regarding the simplification of the Revenue's tax legislation that this article is dealing with, and specifically looks at:

- the "lifetime limit" on pension funds which will retain their tax benefits, the new "recovery charge", and
- the "annual limit" on contributions (or "inflows" as the Revenue refer to them).
- Moving the earliest age at which benefits can be taken from 50 to 55 by 2010.

What is Lifetime Limit?

This "lifetime limit" as it will be known of £1.4 million, is the fund which the Revenue consider necessary to provide a pension broadly equivalent to the Revenue maximum for a male aged 60, where a pension which increases in line with RPI is chosen and includes provision for a surviving spouse's pension. The Revenue actually state that "For most people this limit will be well above the value of the pension fund they expect to get at retirement", however, this will be of little comfort to people that need to make greater provision. The limit will be indexed, probably in line with prices (or possibly earnings).

An amount equal to 25% of the fund will be available as a *tax-free* lump sum with the balance providing a taxable income.

Where an individual's fund is valued at more than this lifetime limit, any amount above the limit will be subject to a "recovery charge" of one third of the excess which will be payable to the Revenue. This is the Revenue's way of neutralising the tax relief on contributions paid and tax advantaged growth during investment for that part of the fund in excess of the lifetime limit. You will then be able to take 25% of the remaining excess as a lump sum with the balance being used to provide an income. Both the lump sum and income in respect of the excess remaining after the recovery charge has been applied *will be subject to income tax*.

The effect of this recovery charge actually means that a higher rate tax payer (based on the current highest rate of 40%) would effectively suffer tax at 60% on the benefits provided by the fund in excess of the lifetime limit.

If you are fortunate enough to have a fund in excess of the lifetime limit at A-Day, the Revenue have confirmed that you will have a higher personal "lifetime limit" equal to that amount, which will again be indexed.

For those that can afford to "crash fund" their pension and will need a fund in excess of the proposed limit in order to provide sufficient retirement benefits, they have the ability to engineer a higher "personal" lifetime limit by making larger contributions now. Come A-Day, they could then stop making any further contributions to try and avoid ever being caught by the recovery charge. It may also be necessary at this time to consider the underlying investment strategy for your pension fund. If your fund grows at a faster rate than the rate at which your personal "lifetime limit" is indexed, again, this could create a recovery charge unnecessarily.

Annual Limit on Contributions ("Inflows")

The annual limit on inflows to a person's pension arrangement will be £200,000 per annum. Like the "lifetime limit" this will also be indexed each year.

Post A-Day, an individual can only pay this level of contribution and get tax relief on the whole contribution if their UK chargeable earnings are at least £200,000. Basically, clients who are resident and ordinarily resident in the UK will receive tax relief on the higher of £3,600 or 100% of UK chargeable earnings.

Employer contributions of £200,000 for directors of Private Limited companies should be offsetable against profits as a trading expense, irrespective of the form in which they take their remuneration from the business.

This is a major advantage, in that at present, a good level of salary would normally be required in order that decent pension contributions could be made for directors. With the increased levels of National Insurance introduced by the Government at the beginning of this tax year, the argument for taking less salary and higher dividend payments has become even more sensitive. This will therefore be excellent news post A-Day.

There is a potential downside to this new limit. For those companies with large amounts of taxable profit, there is currently the ability to pay up to £500,000 as a special (or single) contribution to an Occupational Pension for a director, assuming that there is sufficient salary and service with the company. This will disappear come A-Day with the introduction of the new £200,000 limit.

For those companies in a position to do so, making a very large special contribution before A-Day would be sensible. This may well enable them to create a personal "lifetime limit", as mentioned earlier, and so "crash funding" the directors pension to avoid the recovery charge.

Earliest retirement age

One of the other significant changes will be the age at which benefits can normally be taken. The earliest age from which a pension can be taken will be raised from 50 to age 55 by 2010. They are apparently delaying the introduction until 2010 to give people that want to retire earlier, the chance to rearrange their affairs accordingly! It is not yet known whether the new rules will insist on this change being phased in from implementation to 2010 or whether they will leave it up to each scheme to decide on how this is introduced. They helpfully point out that this does not stop people from still retiring before age 55 from 2010, however, they will need to rely on other resources until their pension benefits kick in! Those in special occupations such as football players, who have been used to retirement ages as early as 35, are also likely to be affected by the earliest retirement age 55 proposals!

Please contact Graham Thomas in our Chelmsford office on 01245 256926 for further information or for a detailed review of your existing pension provision and how the Green Paper proposals will affect you.

VAT FLAT RATE SCHEME FOR SMALL BUSINESSES

The VAT Flat Rate Scheme for small businesses was originally introduced in the 2002 Budget, but in the past few months there have been certain changes in respect of its availability for small businesses.

The Flat Rate Scheme (FRS) basically offers small businesses an alternative to the normal transaction based method of VAT accounting, in that it enables eligible businesses to calculate the VAT payment as a simple percentage of their total turnover. The Scheme is available to small businesses whose annual taxable turnover does not exceed £150,000, and whose total turnover (including the value of exempt and non-taxable income) does not exceed £187,500 a year.

The main aim of the scheme is to reduce the administrative burden placed on small business for accounting for VAT.

For many small businesses the completion of a VAT Return can be quite tedious and onerous as under normal rules the VAT on each sale has to be identified and the value of the sale and VAT need to be recorded separately. Similarly under normal rules, a similar method of recording is required in respect of purchases in order to reclaim Input Tax. Under the FRS, such a recording of transactions for VAT purposes is not required, and any VAT owed is simply calculated as a percentage of total business supplies (including exempt supplies) in each period. HM Customs and Excise have introduced a variety of Flat Rate Percentages for different trade sectors which have been set at levels in order to take into account the average reclaim of Input Tax being made by businesses in those sectors.

As under the normal rules for accounting for VAT, the turnover used under the FRS can be that on an invoice basis or on a receiving payment basis.

In general, under the scheme a separate claim for Input Tax is not made, however, there are two exceptions to this rule:

1. VAT on stocks and assets held on registration can be recovered in exactly the same way as with the normal rules. Recovery for VAT on pre-registration assets can be made. Any subsequent disposal of such assets has to be accounted for, also in the normal way, in that VAT has to be calculated and added to the Flat Rate calculation of tax due.
2. If the business buys a capital asset post-registration with an invoice value of £2,000 inclusive of VAT or more, a claim for input tax can be made on the VAT Return in the normal way. But again, if this treatment is used, any subsequent disposal of this asset, would also have to be accounted for, using normal rules.

It is important to note that, even if using the FRS, a VAT invoice has to be issued to your customers and the scheme only effects the way in which the VAT is calculated, thus not changing the VAT rate applicable to the supply. That is a normal VAT invoice would be issued in which the business would charge VAT at the normal rate for the supply and not the Flat Rate Percentage.

The above details only a brief outline of the scheme and its availability and should you require further in-depth detail on the mechanics of this scheme and the registration process, please contact Deval S Patel.

SHOULD I CONTRACT OUT OF SERPS?

This is currently a major issue and likely to continue for some years to come. Both AXA and HSBC have come out with some simple and categorical advice that "no-one should contract out" and "unless the levels of rebate from the Government are increased, anyone who is currently contracted-out should contract back in".

A quick reminder of what SERPS relates to. Presently, the Government provides two elements to State Retirement Pension. The first is the well known basic State Retirement Pension. The second is a top-up Pension that relates to earnings of employed individuals throughout their working lives. That second Pension can be "contracted-out", such that you stop building up benefits in the State Second Pension. Instead, the national insurance that would have gone towards a State Second Pension is diverted towards a private Scheme. That money takes the shape of a national insurance rebate worth several percent of your earnings. If you like, the rebate is a bribe for taking yourself off the State's hands. It is only worth doing this if you have a fighting chance of being better off as a result. The rebates are supposed to be set at a level that means it is a neutral decision whether you are in or out. However, this is a very complex process and one that is only reviewed by the Government every five years. As we all know, economic conditions change far quicker than that and the general conclusion is that the rebates being offered for contracting-out are so inadequate that one is better off back in the State Scheme.

Ultimately, this is an investment decision. The rebates from the Government are invested and ultimately produce a Pension for you. Whether or not this Pension is greater or lower than the State Pension you have given up will depend on several factors, including investment returns and annuity interest rates at the time you retire.

However, if you are confident that investment returns in the future are likely to comfortably exceed the rate of increase in national average earnings, then you may feel that it is appropriate to contract-out. If, on the other hand, you feel that investment returns are likely to be on the low side, you may determine that you should remain in the State Scheme.

There are some other important points to consider. For men and many women, the Second State Pension benefits are not available until age 65. The replacement benefits from your Personal Pension Plan are available from age 60. You may consider that the accessibility of benefits from age 60 is attractive. If you are a single person but with a partner, you may consider the death benefits available prior to retirement to be more attractive from a private Plan than from the State. Indeed, you may have little confidence in the continuation of the State Pension System. Many younger people believe that the State Pension System will be subject to further detrimental changes in the future. There is currently a Green Paper on the reform of all Pension Schemes that is likely to come into effect from 6 April 2005. It is suggested in that paper that it might be possible to take benefits from a Contracting-Out Personal Pension at age 55 rather than from age 60 and to take some of those benefits in the form of a tax-free cash lump sum. Currently, this is just not possible. The Second Tier State Pension can only provide an income and then if you are still alive at the age of 65.

Do remember that the State Basic Pension is unaffected by your decision to contract-out of the State Second Pension.

If you want to check exactly what your State Pension entitlement is going to be, the Department for Work & Pensions offers an excellent service by completing a Form BR19 (we can supply on request) which provides you with a free Pension forecast telling you that based on your national insurance contribution record to date and certain assumptions about the future, what your State Benefits will look like. Any of the directors of Gerald Edelman Financial Solutions Limited will be happy to assist you in considering your options.

TAX PLANNING FOR PROPERTY INVESTMENT AND DEVELOPMENT

This article sets out some of the key tax issues which need to be addressed when you are carrying on a property business. It deals with both incorporated and unincorporated businesses, and describes a number of tax-saving opportunities.

ARE YOU TRADING?

The tax treatment differs according to the precise nature of the business.

It is important to determine at the outset whether you are trading or investing. This is a complex issue but – in broad terms – you will be carrying on an investment activity if you hold property on a medium-term to long-term basis, and are concerned with receiving rental income rather than short-term profits on disposals.

On the other hand, if you build houses/flats for sale or you develop offices/shops for sale, this will almost certainly be a trading activity.

The position is more complex if you carry on a "mixed" business. For example, you might build or refurbish a block of six flats, sell four and retain two for investment purposes. You will then be carrying on both investment and trading activities, and it will usually be advisable to separate the two activities. This might be done by carrying on the trading activities in a company. This might sell the two "investment" flats to yourself to hold personally; the problem here is that the company will pay tax on the profit realised on the sale. However the ideal situation in this example, would be for the proposed investment in the two flats to be held from the beginning by a separate entity or by you as an individual. In this way, any capital gain that accrues from the development profit will not be taxable until either or both flats are sold.

If you are contemplating trading as well as investment, we can help you to review your choices to achieve the best operating structure.

CAPITAL ALLOWANCES

If you buy commercial properties for investment (whether directly or via a company), it may be possible to reduce tax liabilities by claiming capital allowances.

Generous reliefs are available on expenditure on commercial buildings in Enterprise Zones. No relief, however, is available on the land element.

Allowances are also claimable on industrial buildings, wherever they are located, but again the land element has to be excluded.

It will frequently be possible to claim substantial amounts of capital allowances which will lower purchase costs on "plant and machinery" in offices and shops. This applies both to new buildings and to "second-hand" buildings. In the latter case, careful analysis often reveals that the plant element is much greater than might initially be expected.

The following are examples of types of expenditure which may qualify as plant and machinery.

Lifts and escalators.	**Air conditioning.**
Burglar alarms.	**Installation of hot water supply.**
Sanitary equipment.	**Emergency/security lighting.**
Boilers.	**Computers.**
Cold stores.	

STAMP DUTY

This can be very costly. For instance, if you buy a property costing over £500,000, Duty will be 4%.

It may be possible to reduce the Duty if the vendor is prepared to sell you the company which holds the property rather than the property itself. Stamp Duty will then be payable at only 0.5% on the value of the shares.

However, great care is needed when considering the purchase of a company in these circumstances, since it may bring unexpected liabilities relating to its past history. Professional costs can be higher when buying or selling a company.

You may wish to consider using a separate "vehicle company" each time you buy an investment property, so that you can offer Stamp Duty savings to a purchaser in due course along the lines discussed above. There are anti-avoidance rules which can apply if a company transfers a property to a "vehicle company" which is a member of the group, prior to onward sale to an outsider, so it is advisable to use a vehicle company (where desired) from the outset.

As described later, "vehicle companies" can give rise to certain tax problems.

VAT

It is important to ensure that you minimise your VAT liabilities when dealing with properties. If you get it wrong, it may cost you an extra 17.5% on your expenditure!

It is particularly important to review your VAT position before you commence activities, before you begin a development or refurbishment and before you sell your business or any property.

It should be borne in mind that the VAT treatment of residential property differs from the VAT treatment of other properties.

SPECIAL RELIEFS

We give below brief details of how certain tax reliefs operate in connection with property matters:-

- The Enterprise Investment Scheme ("EIS") offers Income Tax and Capital Gains Tax Reliefs when you subscribe for shares in a qualifying trading company, provided that a number of criteria are met.

  For this purpose, a property development company does not normally qualify, but a company which builds houses on an ad hoc basis for individuals on land belonging to the individual is likely to qualify.

- Enterprise Management Incentives. This scheme enables options to be granted to employees of trading companies on a tax-efficient basis.

  As far as property companies are concerned, the position is as described above in connection with EIS.

- Taper Relief is a very attractive Capital Gains Tax relief for an individual who invests in an unquoted trading company, whereby the maximum effective tax rate on disposal after at least two years

GENIE PROPERTY BUSINESSES *continued*

of ownership can be as low as 10%. This special "Business Assets" level of Taper Relief is available in respect of any trading company, so any property company which is taxed as a trading company will qualify.

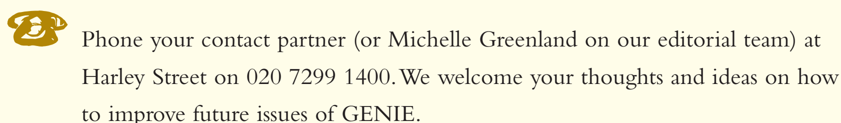
- Business Property Relief. This is a very attractive relief which applies for Inheritance Tax when an individual makes a gift of shares in his (or her) family trading company or holds these shares in his (or her) estate on death. A number of criteria have to be met, but a property development company, but not a land or property dealing company, will normally fall within the terms of this relief.
- Companies. As from 1st April 2002, there is a new "substantial shareholding exemption". This applies where a trading company disposes of shares in another trading company. There are various criteria, for instance, the shareholding must be at least 10% and it must have been continuously held for at least 12 out of 24 months preceding disposal. This means that a group of property trading companies could sell one or more companies and realise a gain without incurring any tax liability provided the criteria are met. This should be contrasted with the situation where the individual properties are sold, when any trading profit would be fully taxable, and any capital gain would be taxable on the company.

HOW SHOULD I STRUCTURE MY PROPERTY OPERATIONS?

This is a very difficult question to answer. The most tax-effective structure will depend upon your own personal circumstances and objectives. It will also be necessary to review the structure regularly to take account of changes in tax law and changes in your particular circumstances.

As mentioned earlier, there could be future Stamp Duty advantages in operating through a company. In addition, a company pays lower rates of tax than an individual. Corporation Tax is nil, 19% or 30%, depending on the circumstances, whereas the top rate of Income Tax is 40%.

GENIE COMMENTS & SUGGESTIONS



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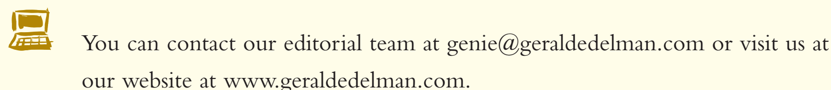

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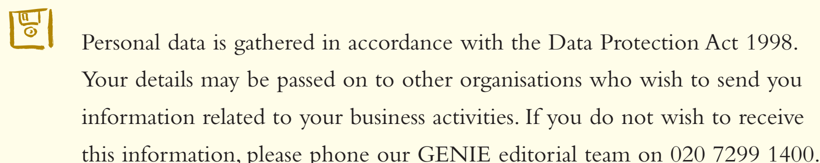

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