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Business Update

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WINTER 2011

Let's make it simple

According to recent government statistics there are three million unincorporated businesses in the UK that have a turnover of £70,000 or less, including approximately two million with a turnover of £20,000 or less. Although these smallest businesses in the UK form a vital part of the UK economy they are said to bear a disproportionate burden when dealing with their tax obligations. So what can be done?

The Office of Tax Simplification (OTS) published an initial report earlier this year on the review of small business taxation. It recommended that structural reform be considered for the taxation of the smallest unincorporated businesses. In particular, they found that tax administration is a key source of uncertainty and complexity for the small business. Ministers have now asked the OTS to look closer at this issue, focusing on all aspects of the interaction between small businesses and HMRC and to come up with concrete recommendations for improvements.

The OTS is also charged with gathering views on two further strands affecting small business tax and has issued two discussion papers as follows:

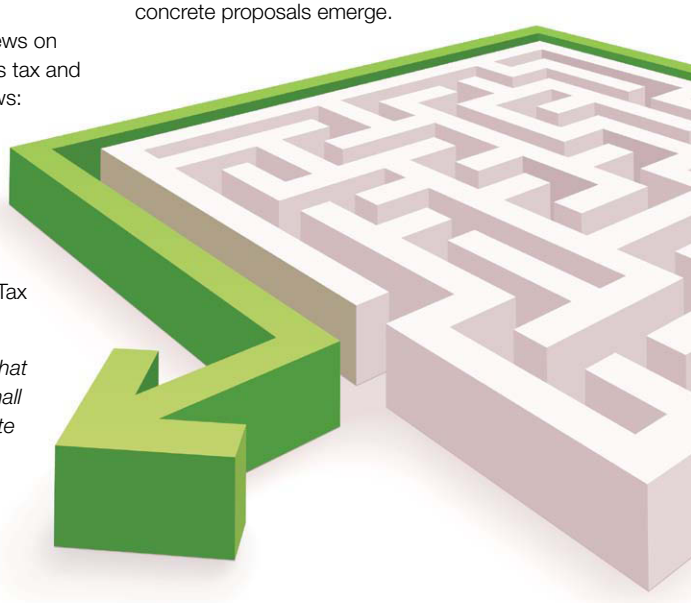
- alternative systems for taxing the smallest unincorporated businesses and
- the case for a relief for disincorporation.

John Whiting, Tax Director of the Office of Tax Simplification said:

'We have been told in no uncertain terms that tax administration can be a problem for small businesses. So we want to stimulate debate and allow those in business, and their advisers, to give us their views on the various possible ways forward.

Would a cash basis be a better way of taxing the smallest businesses? How about flat rate expense allowances? What of the more radical alternatives some other countries use - could any of them work here? Do we need a disincorporation relief? Whether you agree with these ideas or not, we are keen to hear your views.'

The OTS final report on these small business tax reviews is due to be published ahead of Budget 2012. Clearly we will continue to monitor these developments so that we can advise you when any concrete proposals emerge.



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VAT's the problem?

Salary sacrifice arrangements are where an employee agrees to their salary being reduced by a specific amount and the employee then becomes entitled to something instead of that salary. Often, the 'something instead' is a tax free benefit, such as employer pension contributions or childcare vouchers.

This means that the employee saves income tax and national insurance contributions (NIC) on the amount converted into a tax free benefit and the employer saves NIC so everyone gains.

Sacrifice in practice

When entering a salary sacrifice arrangement to replace part of cash pay with a benefit that is tax and/or NIC free, it is essential for employees to understand what the sacrifice will mean in practical terms. Salary is being reduced for all purposes, so employees should carefully consider the effect that a reduction in their pay may have on issues such as:

- their future right to the original (higher) cash salary
- any pension scheme being contributed to
- entitlement to Working or Child Tax Credit
- entitlement to state pension or other benefits, such as Statutory Maternity Pay.

Is VAT a consideration?

A recent court case has altered the VAT position in relation to salary sacrifice schemes. The case concerned the correct VAT treatment of high street shopping vouchers provided to employees as one of the options of the scheme.

The court found that the provision of vouchers amounted to a supply of services for consideration and, as a consequence, whilst the company was able to recover the VAT incurred on acquiring the vouchers, output tax was due on the consideration received from its employees.

Although this case was concerned with the supply of vouchers to employees, the principles apply to other supplies of goods and services to employees.

HMRC have previously accepted that the reduction in the salary did not constitute consideration for the benefits received and output tax was not due. This was the position even though employers were able to recover the related VAT as input tax, subject to the normal rules.

The new VAT position

Businesses providing benefits under salary sacrifice schemes must now account for output VAT on these supplies where they are subject to VAT. In order to allow businesses time to make the necessary adjustments, HMRC will not require output tax to be accounted for on taxable benefits provided under salary sacrifice schemes until 1 January 2012.

In most cases the value of the benefit for VAT purposes will be the same as the amount of salary deducted or the amount foregone under a salary sacrifice arrangement. Where this is less than the true value (e.g. where an employer supplies the benefits at below what it cost to buy them in), the value should be based on the cost to the employer.

If your business operates any salary sacrifice arrangements, please do get in touch to discuss the implications for your business.

Act now for allowances!

Now is the time to consider the potential impact of the forthcoming capital allowance changes on your business and whether plans should be put into place to advance expenditure to secure tax relief earlier.

The reductions in capital allowances originally announced last year come into force from April 2012, that is with effect from 1 April 2012 for companies and 6 April 2012 for the self-employed in business.

Reduction in Annual Investment Allowance (AIA)

The AIA provides 100% tax relief on most types of plant and machinery (not cars) including integral features for all forms of qualifying business.

Since April 2010 the maximum annual limit available has been £100,000 but this is to reduce to £25,000 for expenditure incurred from April 2012.

For many businesses, their accounting period straddles the date of change so the old and the new limits have to be apportioned. Unfortunately, the way in which the rules operate mean that there is a restriction so that any AIA entitlement for that part of the accounting period falling on or after 1 or 6 April 2012 is given only by reference to the appropriate share of the £25,000 limit.

This means for example that although a business which makes up accounts to 30 September 2012 appears to have an overall AIA of £62,500 as shown in the example below – the restriction limits the available AIA to just £12,500 for the period 1 April 2012 to 30 September 2012. There is no such restriction in the period 1 October 2011 to 31 March 2012 so the whole of the £62,500 entitlement could instead be spent in that period.

Example

A company makes up its accounts to 30 September annually. For the year to 30 September 2012, the overall AIA entitlement is calculated as £62,500 as follows:

1 October 2011 – 31 March 2012 6/12 x £100,000 = £50,000

1 April 2012 – 30 September 2012 6/12 x £25,000 = £12,500

Tax relief impact

The combined effect of the reduction and the restriction mean that where a small company which currently pays tax at 20%, delays the replacement of some commercial vehicles costing £75,000 from March 2012 to April 2012, then it will lose £10,000 of immediate tax relief!

Writing Down Allowances (WDA)

The WDA rates are also to reduce from 1 April 2012 for companies and from 6 April 2012 for the self-employed.

These annual rates on qualifying plant expenditure not eligible for other allowances such as AIA will move from:

- 20% to 18% on expenditure allocated to the main plant pool and
- 10% to 8% on expenditure allocated to the special rate pool.

Special rate pool items includes integral features and cars with emissions in excess of 160 CO_2 emissions.

The effect of these changes will mean that the period over which tax relief is obtained is extended. In fact according to the Government - 'It is estimated that approximately two million businesses could see an increase in their tax liability as a direct result of this measure.'

So, taking advantage of other opportunities, which may accelerate capital allowances and the corresponding tax relief, becomes more pertinent. Please contact us to review your position.

Encouraging enterprise

The Enterprise Investment Scheme (EIS) is designed to encourage private individuals to directly invest in smaller high risk unquoted trading companies by offering them attractive tax breaks. The scheme has been running for many years but from time to time the tax incentives and eligible conditions are varied. Now the Government is once more seeking to make improvements to the scheme as part of its 'Plan for Growth' announced at the Budget earlier this year. The changes are aimed not only at encouraging individuals to participate in the scheme but also create an opportunity for more companies to be eligible.

Tax breaks for the investor

For investors in shares to obtain tax benefits, the shares must be an investment in newly issued shares of a qualifying EIS company. The benefits potentially available are:

- For shares issued on or after 6 April 2011 income tax (IT) relief is now at 30% (20% for shares issued prior to 6 April 2011), on investments up to £500,000 a year.
- Capital gains tax (CGT) exemption on any gains made on the disposal of EIS shares
- If a capital loss is made on disposal, then some or all of that loss depending on what income tax relief has been obtained is allowable for CGT purposes.
- CGT deferral relief for gains that arise on disposal of any assets against subscriptions for shares in any EIS company.

There are a number of detailed rules that will deny IT relief and the CGT exemption. One key condition for both is the requirement to hold the shares for at least three years.

Another key restriction for IT relief and the CGT exemption but not the deferral relief is connection to the company. If you are connected with the company at any time during the period beginning two years before the issue of the shares and ending three years after that date, or three years from the commencement of trade if later. You can be connected with the company in two broad ways:

- by virtue of the size of your shareholding in the company or
- by virtue of a working relationship between you and the company.

In both cases the position of your 'associates' is also taken into account.

Qualifying companies

Companies must meet certain conditions for any of the reliefs to be available for the investor. In outline these are that:

- The company must be unquoted when the shares are issued.
- All the shares comprised in the issue must be issued to raise money for the purpose of a qualifying business activity.
- The money raised by the share issue must be wholly employed within a specified period by the company, generally two years.
- The company or group must have fewer than 50 employees.
- The amount of capital raised in any 12 month period is limited to £2 million.
- The company must not be regarded as an 'enterprise in difficulty' under EC guidance.
- The company need only have a permanent establishment in the UK rather than carrying on a qualifying trade wholly or mainly in the UK.

Qualifying business activities

A trade will not qualify if excluded activities amount to a substantial part of the trade. The main excluded activities include:

- dealing in land, commodities, shares etc
- financial activities
- leasing
- legal or accountancy services
- property development
- farming and market gardening
- operating or managing hotels etc
- operating or managing residential care homes.

Future changes

Legislation will be introduced to make the following changes to the EIS scheme for shares issued on or after 6 April 2012.

- The annual amount that an individual can invest through EIS is to increase to £1 million.
- The annual amount that can be invested in an individual company is to increase to £10 million.
- The thresholds for the size of the company which may benefit from such investment will be increased from:
  - fewer than 50 employees to 250 employees and
  - from an overall maximum of £8 million gross assets to £15 million.

As you can see the schemes have a number of detailed rules. If this is an area you would like further advice on please let us know.

Research - the sky's the limit

Research and Development (R&D) by UK companies is being actively encouraged by Government through a range of current and proposed tax incentives. One area where tax incentives already operate but where improvements are being made is the area of R&D expenditure for small and medium sized enterprises (SMEs).

R&D tax credits provide extra tax relief for R&D qualifying expenditure incurred by SMEs. There are two main elements to the relief, an increased deduction for R&D revenue spending and a payable R&D tax credit for companies not in profit.

The R&D tax relief increases the amount a company can deduct on qualifying current spending on R&D from 100% to 200% for expenditure incurred on or after 1 April 2011 and the Government intends to increase it further from April 2012.

Not everyone can claim R&D tax credits and not all expenditure qualifies. The most important conditions are:

- **only companies can claim R&D tax credits. R&D tax relief and the payable R&D tax credit is not available to individuals or partnerships**
- **the company must be a small or medium-sized enterprise (SME)**
- **the R&D does not have to be undertaken in the UK**
- **the spending qualifying for relief must not be less than £10,000 a year (restriction to be abolished from 2012)**
- **the spending must not be incurred in carrying out activities contracted to the company by another person (however a slightly different form of R&D tax credit may apply)**
- **the expenditure must not have been met by another person (if the R&D project is funded in whole or in part by State aid such as a government grant, none of the spending on that project can qualify for R&D tax credits)**
- **the payable R&D tax credit is currently limited to the amount of the company's total PAYE and NIC liabilities of the accounting period (but this restriction may be abolished from 2012).**

The first essential thing to determine is whether HMRC would accept that the particular activities constitute R&D. The second is then making sure the relevant tax rules are met.

If this is something that you would like to discuss in more detail, please do get in touch.

Toolkit offers help on input VAT deduction

HMRC have issued a number of toolkits to help taxpayers and their agents file accurate returns. The toolkits highlight the common problem areas. They mainly cover specific technical areas but they also stress the need for good record keeping to support returns. Even where records are well kept, mistakes, duplications and omissions may occur, resulting in input tax being claimed too early, too late or in the incorrect amount.

Reducing penalties

Accurate record keeping is crucial as penalties may be charged on a business which files incorrect returns, especially where sufficient documentation is unavailable to support the returns. This article looks at some of the key issues considered in the input VAT toolkit. Further areas are detailed in the toolkit itself which is available from HMRC's website.

Unpaid suppliers

A business should reverse an input tax claim if the supply remains unpaid for six months after the date of supply or the due date for payment (if later).

Private and non-business use

When expenditure has a mixed business and private or non-business purpose then only the proportion of the input VAT relating to the business use proportion may be reclaimed. There are special rules for assets which are used for business and private purposes, in these circumstances it may be possible to reclaim the VAT in full and charge an output VAT charge to cover the private use (known as the Lennartz approach). This is a complex area so please do get in touch if you believe your business may be affected by these rules.

Change of use

If goods on which input tax has been reclaimed are later put to private or non-business use then an adjustment needs to be made. This is usually done by charging output tax on the supply.

Partial Exemption

Many businesses are partially exempt, meaning that they make exempt as well as taxable supplies. Where a business is partially exempt it may only reclaim a proportion of its input VAT subject to a de minimis test (£625 a month).

Business entertainment

VAT on business entertaining is not recoverable. However a business sometimes incorrectly treats this expenditure as advertising and claims the input tax in error.

Cars and motoring expenses

- VAT is generally not recoverable on the purchase of cars and is restricted to 50% on leased cars.
- Where input VAT is claimed on the purchase of total fuel costs for a car then there is an output tax charge due to cover the private use.

International transactions

This is a complex VAT area. In particular many services purchased from overseas suppliers require the UK recipient to account for both output VAT and input VAT on the same supply. This is known as a reverse charge and we can assist your business by reviewing the exact position in relation to international supplies.

If you would like any help in calculating input VAT recovery please do not hesitate to contact us.

Changes ahead for non-doms

The tax treatment of non UK domiciled individuals is by no means straight forward .The starting point of liability for all non UK domiciles is that overseas income and gains are taxable on the arising basis just as they are for any UK domiciled individual.

The non UK domicile then has the option of making a claim for the 'remittance' basis to apply, meaning that they are only assessed on overseas income and gains treated as received in the UK. However, if they make this claim, they will automatically forfeit their personal allowance for income tax purposes and their annual exemption for CGT. This will obviously impact on their total tax liability which also includes all UK income and gains.

Matters become more complex and serious when an individual falls within the definition of a long term UK resident. This will arise when the individual has been resident in the UK in seven out of the nine UK tax years preceding the one for which liability is being considered. If they have been UK resident for at least seven of those years then they will be classed as a long term resident for the purpose of the remittance basis.

Essentially the long term resident (who must be 18 years of age or over at some time in the tax year concerned) can only claim the benefit of the remittance basis (with minor exceptions) if they pay an additional £30,000 in addition to the tax on any income or gains remitted. This sum is known as the 'remittance basis charge' (RBC).

The Government is now consulting on measures to introduce the following additional reforms from April 2012.

The measures will:

- remove the tax charge when non UK domiciles remit foreign income or capital gains to the UK for the purpose of commercial investment in UK businesses
- increase the existing £30,000 annual charge to £50,000 for non-domiciles who have been UK resident for 12 or more years and who wish to retain access to the remittance basis of tax and
- simplify some aspects of the current rules to remove undue administrative burdens.

The Government has confirmed that there will then be no other substantive changes to these rules for the remainder of this Parliament.

If these proposals are likely to have an impact on you and you would like to discuss the position as it affects your personal circumstances please do contact us.

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