

Our Budget predictions

Budget day is 12 March 2008 - earlier than in recent years, and on a Wednesday instead of the normal Tuesday! We already know much of what is in store - the Pre-Budget Report announced a raft of measures, including:

- capital gains tax reform
- the non-domicile and residence rule changes
- transferable nil-rate bands

Draft legislation has also already been published on other important matters, including:

- income shifting
- a new capital allowances regime
- overseas holiday homes

Some progress may be announced on other measures that are currently under consultation or discussion, including:

- the taxation of foreign profits and reform of Controlled Foreign Companies rules
- financial products avoidance involving disguised interest and the sale of income streams
- a new tax appeals system
- a clampdown on employee car ownership schemes
- tax incentives for the development of brownfield land.

In general terms, this is likely to be a tax-neutral or tax-raising Budget - the Institute for Fiscal Studies estimated that an extra £8bn would have to be raised to meet borrowing commitments. The picture may, however, be slightly better in light of the recently reported increased tax takings.

The Chancellor said in December 2007 at a conference on green issues that "Sustainability will be at the heart of the next Budget". We may therefore see some 'green tax' increases or incentives.

It has already been announced that the full corporation tax rate will be reduced to 28%, and the small companies rate will rise to 21% (and to 22% from April 2009) - are these rates destined to meet in the near future? A Chancellor who has made simplification of the tax system an objective may be attracted to the idea of dispensing with the distinction between small and large companies. The associated companies rules, which are causing considerable problems at present, would certainly not be missed by business owners and their advisers.



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Budget Day - Wednesday 12 March 2008

straightforward

Like you, we're straightforward people. We give you straight advice, you take your business forward. No nonsense. Straightforward isn't it?

New HMRC penalty regime

HM Revenue and Customs (HMRC) is changing its penalty regime for the submission of incorrect tax returns. The new system replaces the existing rules for Income Tax Self Assessment, Corporation Tax Self Assessment, PAYE/NIC (including the Construction Industry Scheme) and VAT. The aim is to create a consistent approach in the calculation of penalties across the various taxes.



The new regime, expected to apply to all return periods commencing after 31 March 2008, introduces a behaviour-based approach to penalties. There are three categories:

- "Careless" behaviour (minimum penalty 15%, maximum penalty 30%);
- "Deliberate understatement" (knowingly making incorrect returns) (35% to 70%);
- "Deliberate understatement with concealment" (i.e. knowingly making incorrect returns and then covering the fact) (50% to 100%).

A further reduction in the penalty can be obtained where an "unprompted" disclosure is made. This reduces the above minimum penalties to 0%, 20% and 30% respectively.

Under the new system, a penalty will not be charged where the taxpayer has taken "reasonable care". Also, suspended penalties are introduced. These will only be used in the first category above. Where appropriate, HMRC will suspend all or part of a penalty for up to two years. Providing sufficient action is taken by the taxpayer to correct problems, that part of the penalty which has been suspended will be waived.

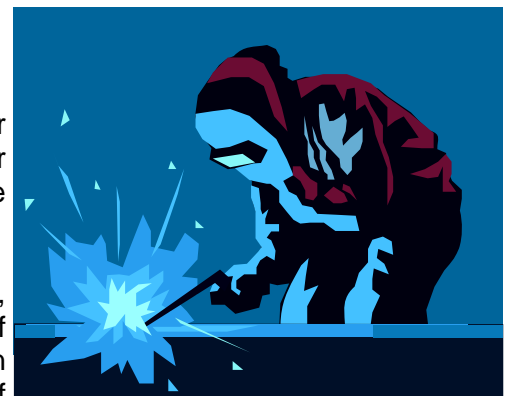
Although the new regime is designed to create a more consistent approach, it is not perfect. The level of penalties is far higher than are sought by HMRC under the current system. We envisage that there will be numerous arguments over whether "reasonable care" has been exercised. If that cannot be demonstrated, then there will be negotiations to determine which category any particular offence falls into, as this clearly will have a significant effect on the level of penalty.

The message going forward is that extra care will be required when completing tax returns to avoid incurring the heavy penalties that can follow from mistakes and omissions.

Construction Industry Scheme

'Self employed sub contractor' is a phrase that we would hear much less if HM Revenue & Customs successfully applied their interpretation of case law. The question is 'what defence do we have?' Well the answer is 'plenty'.

The problem: Self employed is not defined within legislation, although employee is. However, when you read in s230(1) of Employment Rights Act 1996 that it defines an employee as "an individual who has entered into or works under a contract of employment" you know that this won't help!



The guidance for deciding self employment is in case law and we should not view hourly rates, day rates, labour only or a long history with the same contractor as reasons for why an individual cannot be self-employed. These factors, along with others, have all been considered by the courts. It is necessary to get the weight of their importance right and in our experience HMRC get this wrong all too often even though, and perhaps surprisingly, the case law is very positive for the self employed.

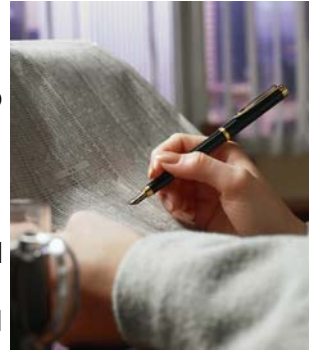
Maintaining a fluid and flexible workforce is often vital to your business and we can help you maintain that by risk assessing your exposure to claims for back tax and NI by HMRC and advising you on what needs to be done to reduce that risk.

Changes to Capital Gains Tax

From 6 April 2008 substantial changes to Capital Gains Tax (CGT) will apply to individuals, trustees and personal representatives, but **not** for companies.

Finance Act 2008 will introduce the following changes:

- A main rate of CGT of 18% will apply to all gains other than those covered by the new entrepreneurs' tax relief or the CGT annual exemption
- A lower rate of 10% for gains on certain business assets which are covered by the new entrepreneurs' relief (see below*)
- Capital gains will not longer be taxed by reference to income tax rates and bands
- The following will be abolished:
 - taper relief
 - indexation allowance (currently frozen at April 1998) in most cases
 - 'halving relief'
- Rebasing of cost to 31 March 1982 value will be compulsory for assets held at that date
- Simplification of the rules for matching certain assets (mostly shares) disposed of with assets acquired
- The new Entrepreneurs' Relief will be available in respect of gains made on the disposal of certain business assets.



*not exactly, slightly higher rates apply if the CGT annual exemption is unused.

Entrepreneurs' relief

Although not dissimilar to CGT retirement relief which was phased out in 2002/03, eligibility for this relief will not depend on age or illness conditions and the qualifying holding period will be only one year.

The first £1 million of **lifetime** gains on qualifying business assets will be charged to CGT at an effective rate of (close to) 10%. Well, not quite. What happens is that the gain is reduced by 4/9 before being taxed, which is better for small disposals and not so good for larger ones. Gains in excess of £1 million will be charged at the normal 18% rate.

An individual will be able to make claims for relief on more than one occasion, up to a lifetime total of £1 million of gains qualifying for this type of relief. This will render ineffective some of the strategies used in recent years to convert income to gains by transferring them across different business entities.

The new relief will be available for any of the following types of transactions by individuals:

- Disposal of all or part of an unincorporated business or partnership
- Disposal of assets following the cessation of a business
- Disposal of shares and securities in a trading company (or the holding company of a trading group) provided that the individual making the disposal has been an officer or employee of the company or one in the same group and owns at least 5% of the ordinary share capital of the company, and is entitled to exercise at least 5% of the voting rights.

A 'business', in terms of this relief will be any trade, profession or vocation, excluding property letting business, but furnished holiday letting is treated as a trade for this relief. Draft legislation is expected in the coming weeks for entrepreneurs' relief and until then we will have to wait and see if there are any transitional provisions and whether the 'lifetime allowance' starts rolling on 6 April 2008 or is actually from birth.

Employee share schemes

No changes have been announced for "tax advantaged" employee share schemes from 6th April 2008, other than in tax rates.

All gains made on approved schemes (including EMI schemes) will be taxed at the flat rate of 18% after deducting the annual exemption.

Employees who hold less than 5% of the voting capital of their employers companies may lose out due to the loss of the business asset taper relief under the new rules, because entrepreneurs' relief would appear not to apply. Employees who hold stakes of over 5% of shares and voting rights may well be eligible for entrepreneurs' relief.

Other existing CGT reliefs

Other existing reliefs will continue to be available post 6 April 2008 for:

- Principal private residence relief and letting relief
- Business asset roll over relief
- CGT relief under the VCT and EIS schemes
- Business asset gift hold-over relief
- Losses may still be carried forward

Planning points

Banking v. losing indexation

Indexation will no longer apply from 6 April 2008 and some spouses have an opportunity to consider 'banking' their indexation allowances through inter-spouse transfers. Our December 2007 newsletter explained how this can be done. The draft legislation is now changed so that the anomaly in cases where an asset was originally acquired pre 31 March 1982 no longer applies and indexation will be available to increase the base cost on the second disposal.

Business disposals, QCBs and business asset status

- The new entrepreneurs' relief applies from 6 April 2008, and there is no detail yet about any transitional reliefs which could cover situations where part of the consideration for the disposal of a business prior to 6 April 2008 is in qualifying corporate bonds (QCBs) redeemable post 6 April 2008. Without any transitional measures, and if entrepreneurs' relief does not apply, gains on the QCBs when cashed would otherwise be taxed at 18%.
- Even though business asset taper relief disappears from 6 April 2008, Entrepreneurs' relief is dependent on there being a qualifying business ongoing. It will therefore be essential to ensure that the business is a qualifying trade, profession or vocation (or holiday let), which mean the former **20% test** lives on post 6 April 2008. This test measures non-trading activities, which must not be substantial (i.e. account for more than 20% of turnover, or assets or profits). This means that businesses will have to continue to watch the size of cash balances or investment activities after all.

Deferred gains

Where a gain has been deferred under, say, the Enterprise Investment Scheme (EIS), indexation allowances accrued up to 5 April 2008 will not be lost when the gain becomes chargeable after that date. Taper will not apply to deferred gains from 6 April 2008. The position for some deferred gains which would have formerly attracted halving relief and from 6 April 2008 require some further verification from HMRC.

Non-business asset, mixed use asset disposals

Following introduction of the new regime there will not be 'tainted' or mixed taper relief problems. However, some exclusive business use may still be detrimental in some cases, where it might deny other reliefs, such as the principal private residence relief.

Worse perhaps is the new definition of a business asset. At the time of writing, a business seems to be only those falling into the categories listed above. One obvious omission is property let to trading businesses or companies in which the landlord has no interest - gains on the disposal of such properties have been eligible for business asset taper relief since April 2004.

Share portfolio investors

A lower rate of taper relief currently applies to non-business assets, such as shares quoted on the stock market and unit trusts. Depending on the length of time for which the shares or units have been held, this may reduce the chargeable gain by up to 40% and the effective rate of capital gains tax paid by a higher rate taxpayer to a minimum of 24%, and by a basic rate taxpayer to a minimum of 12%. However, the position is further complicated by the fact that indexation allowance, which may be available in addition to taper relief, will be abolished for sales on or after 6 April 2008.

If a useful amount of taper relief (or taper relief plus indexation allowance) is currently available on a particular holding, an investor may wish to consider making a disposal within his 2007/08 annual exemption, to take advantage of the accrued taper relief and indexation allowance before it is lost forever. 'Double bed-and-breakfasting' (sale by a husband and repurchase by his wife, or vice versa) may be used to crystallise a gain within the annual exemption. However, we would recommend you take advice before entering into any such transaction which creates or utilises a capital gains tax loss, as the Finance Act 2007 included some complex anti-avoidance legislation which may deny relief in these circumstances.

An alternative is that a straightforward gift or sale between husband and wife (or between civil partners) on or before 5 April 2008 will have the effect of preserving any accrued indexation allowance (but not any taper relief). This might be worth considering where the investment has been held for a long time, so that a substantial amount of indexation allowance is at stake.

Finally, many Alternative Investment Market (AIM) shares count as business assets for taper relief purposes. If they have been held for at least two years, and are sold by 5 April 2008, they will qualify for maximum taper relief, so that the effective rate of capital gains tax will be 10% for a higher rate taxpayer and only 5% for a basic rate taxpayer. From 6 April 2008, both will pay tax at 18% on their gains.

Share pools

As a result of the proposed "simplification", all shareholdings in a single company will be merged into a single pool at 5 April 2008. Shares which were held at 31 March 1982 will be included at their 31 March 1982 valuation and shares purchased subsequently at their qualifying cost. The only shares which will not lose their indexation under this arrangement are those which have been transferred between spouses on a no gain no loss basis, before 6 April 2008 (see above). Special rules will remain for matching acquisitions and disposals made within 30 days of each other.

Buy-to-let landlords

The classic buy-to-let - a house or flat let to a tenant who occupies it as his home - is not a business asset. If it is sold on or before 5 April 2008, the profit on sale is likely to make the owner a higher-rate taxpayer, even if he is not one already, and so the rate of capital gains tax will vary between 24% and 40%, depending on how long the landlord has owned the property. Other things being equal, therefore, the vendor would do better to delay the sale until the 18% flat rate comes into effect on 6 April 2008. However, if you are considering selling a property, please do discuss the position with us, as in some circumstances the facts may produce a different answer (tax is never straightforward!). Also, of course, a firm sale now may be worth more than the hope of a sale later.

Depending on the circumstances, commercial property (for example, a shop) which is owned and let out may qualify as a business asset for taper relief purposes, as may cottages, etc, used for furnished holiday lettings. The position is complex, so personal advice, tailored to your own circumstances, is essential.

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A brave new world?

A remarkably wide-ranging package of tax reforms will come into force in April 2008. Some were announced by Gordon Brown in his Spring 2007 Budget, others by his successor, Alistair Darling, in his Autumn Pre-Budget Report. The headlines included a reduction in the basic rate of tax, to 20% for 2008/09, and new rules for taxing people from overseas who come to work in the United Kingdom - though the latter will affect high-earning City executives rather than plumbers and chambermaids from Eastern Europe. Some of the news was wholly bad - notably the phased abolition of capital allowances for agricultural and industrial buildings. And some of the changes, although straightforward at first sight, turned out to have surprisingly complex consequences.



In this newsletter we would like to focus on the two most significant changes for small business owners and for investors - the new 'Annual Investment Allowance' for purchases of machinery and vehicles, and the reform of capital gains tax.

Enterprise Management Incentives

Often, one of the factors resisting the growth of small and medium sized companies is the difficulty of attracting, retaining and motivating high calibre executives. These executives will have the knowledge, enthusiasm and drive to grow the business and their continued involvement with the business is essential. There may not be sufficient cash available - or maybe something more than just money is needed to provide the required motivation. By utilising a part of the company's equity value, Enterprise Management Incentives (EMI) provide a flexible way of remunerating emerging executives in a tax efficient form.



EMI is particularly suitable for new and growing companies. EMI allows SME's to award options over the company's shares at a specified price, and capable of exercise within ten years. EMI will provide the maximum tax benefits where the potential for growth in equity value is greatest. EMI is open to most companies with gross assets of less than £30 million.

The features and benefits on an EMI option scheme include:

- A Corporation Tax deduction when the options are exercised
- Taper relief (whilst it is still available but note that this is likely to be abolished) starts from the date of the award of the options (and not date of exercise)
- Each executive can receive options worth up to a total of £100,000
- Total options must be less than £3 million
- No income tax or national insurance is payable by the employee at grant (or at exercise) if options are exercisable at a price equal to or greater than market value at the time of grant
- profits made by the employee are liable to Capital Gains Tax, meaning significant tax savings compared to any other type of option scheme
- No employer's NIC - a saving of 12.8%
- Specific performance criteria for each executive can be defined - sales targets for the sales director or production targets for the factory manager
- Significant flexibility in deciding who participates, on what terms and on how to deal with leavers
- Safeguards can be incorporated to deal with takeovers and other changes in circumstances.

If you are interested in establishing an EMI scheme, call us for further advice.

Missing out on tax relief?

Companies that are carrying on Research and Development ('R&D') activities may be missing out on tax savings. If your company has been undertaking R&D for any tax periods ending in the period between 31 March 2002 and 31 March 2006, you only have until 31 March 2008 in which to make a claim to HM Revenue & Customs for R&D tax credits. After that date, it may be too late and those tax savings lost!



It is not only companies with men in labs wearing white coats that qualify for R&D tax relief! Companies across a wide range of industries and fields may qualify to make an R&D claim to reduce their tax burden. Where a company has achieved advancement in its specific field as a result of overcoming any technological or scientific uncertainty, there is a potential R&D claim to be made that can save the company tax. The R&D regime applies to companies only. Both SME's (i.e. companies with less than 250 employees and with either a maximum turnover of €50m or a balance sheet total of under €43m) and large companies. These limits are soon to be increased to 500 employees, €100m turnover and €86m balance sheet total.

For SME's, a company may claim 150% of qualifying expenditure (to increase to 175% with effect from 1 April 2008). So for £10,000 of expenditure, the company may claim tax relief on £15,000. In addition, if an SME is loss making it may claim a tax refund via the R&D regime obtaining an immediate cash flow benefit. For large companies, they can obtain tax relief on 125% of qualifying R&D expenditure (to be increased to 130% with effect from 1 April 2008). However, no tax refund can be claimed by large companies.

If you consider that there is even just a remote chance that your company may qualify for R&D tax credits, please call us straight away as time is running out.

Income shifting: The debate begins

Following its announcement after its defeat in the Arctic Systems case, the Government has published a consultation paper on draft legislation designed to prevent a tax advantage being gained through "income shifting."

The new legislation is intended to apply from 6th April 2008 to two forms of income:

- profits from a partnership; and
- company distributions, most commonly dividends



It is broadly designed to catch married couples or civil partners who seek to share business profits that have been generated substantially by the efforts of only one individual in the relationship. The proposed rules are very widely drafted. They will catch many owner-managed businesses involving husbands and wives and other family members. The difficulty will be working out whether they are caught by the definitions or not. This will lead to yet more uncertainty for many entrepreneurs, who are likely to have to spend much more time looking over their shoulders to see if HMRC will attack their structure. Many spouses do not have formal meetings to discuss their business arrangements, they just have their own way of working together. Owner-managers will need to try and establish whether their existing dividend or profit allocation is still acceptable and for many businesses this will be no easy task.

Three other conditions must apply:

- the individual who is doing "the shifting" is a party to relevant arrangements, or has the power to control or influence relevant arrangements
- that individual forgoes income (directly or indirectly), as this is shifted to another individual
- the individual doing the shifting has the power to control or influence the amount of the shifted income

The individual who has shifted his or her income to another individual will then pay tax and NI (as applicable to partnership profits) on the income shifted.

The legislation is not intended to apply to genuine commercial arrangements, or arrangements that are the same as those that would have been entered into in dealing with an unconnected party on an arm's length basis. "The power to control or influence..." ensures that income from most PLC shares will not be caught by the proposals.

In addition, the legislation would not apply where:

- gaining a tax advantage is not the main or one of the main purposes of the arrangements;
- the individual whose income is shifted has no power to control or influence the amount of the income; or
- notwithstanding that income shifting has taken place, there is no overall tax advantage.

The underlying problem in trying to legislate to prevent "income splitting" is that not every case is clear cut, and that in the modern era spouses in business tend to make varying contributions to business over time.

A problem touched on in the Arctic Systems appeal to the House of Lords was the question as to whether you could ever compare in truly commercial terms a business partnership made between a married couple (the term includes Civil Partnerships here) to one between two otherwise unconnected persons. If the couple get on, they might be said to have a major commercial advantage over rivals because they can "talk shop" at all hours, and work more flexibly. The other difference is that if you have your spouse in business with you, you can generally get them to do more hours which means that arm's length comparisons are not always possible. The reality is that family businesses do not and cannot possibly operate on a fully arms length basis.

The consultation document seeks comments on the draft guidance as well as the legislation, to ensure that the legislation is clear to businesses and their advisers, and that administrative burdens are minimised. The consultation period will close on 28 February 2008.

Setting up a business overseas

The first steps into a new market are an exciting and important time for any business. Although this may have become a more straightforward process in recent years, there is still much to think about, not least of which is the structure under which the business will operate. There are a number of options, determined by both the jurisdiction in which the business will operate and the nature of the activities to be undertaken. For example, to investigate a new country whilst undertaking market research etc, a representative office may be most appropriate. When you start to make sales in the local market decisions will need to be made as to whether a branch or corporate structure will produce the best results.



In addition to the corporate structure, the issues of investment in the new business and repatriation of cash and profits (once available!) need to be thought through at the earliest opportunity. Various jurisdictions have rules regarding minimum levels of capital, the permissible ratio of debt to equity (“thin capitalisation”) and the requirement to establish reserves to, for example, provide for employees. To achieve a successful entry into a new market, all these issues must be addressed. For the first time entrant overseas or even for the seasoned international businesses, reliance on your tax adviser to deal with the issues, in which he is the expert, giving you the time to focus on the commercial requirements is a winning formula.

Non-doms - an update

The Government's draft legislation on tax hikes for non-domiciles, released last Friday, has dismayed tax advisers who fear economic and charitable contributions made by non-doms may disappear abroad along with fine art masterpieces. The long-awaited draft legislation is both complex and very extensive - “a dog's dinner” in other words! The draft legislation is of such volume and complexity that it adds further weight to calls to delay implementation by a year to get it right.



In a press release, HM Revenue & Customs confirmed that the draft rules will levy a £30,000 charge on non-domiciliaries who have been in the UK for seven of the last 10 years and want to continue to have off-shore income kept tax free. The draft document also suggests that non-doms choosing to keep income offshore tax free will lose all personal allowances for UK-earned income and capital gains.

On the other hand, the £30,000 charge will be an annual tax charge, and each year individuals will have the choice of whether or not to pay the charge and claim the remittance basis. A decision not to claim the remittance basis in any given year does not close off the option of claiming it in subsequent years. However, only those with unremitted income in excess of £80,000 are likely to pay the charge; others will find it less costly to opt out of the remittance basis.

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Newsletter Content

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.

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