NEWSLETTER • SPRING 2006

BRONSENS

CHARTERED ACCOUNTANTS
REGISTERED AUDITORS

A wider scope for work in progress

If you run a business that provides services, you may face a tax enquiry unless you adopt new rules on recognising income.

A change in accounting practice means that where you have a service contract in progress at the end of your accounting period, the accounts must include a proportion of the contract income corresponding to the contract's stage of completion. For example, if the contract is 60% complete, then 60% of the income must normally be included in your accounts, even if it cannot be billed yet.

HM Revenue and Customs (HMRC) has said that it expects all businesses to adopt the new practice, which goes by the title UITF 40, for periods ending after 22 June 2005. This will generally result in a one-off 'catching-up' tax charge in the tax year in which that accounting period ends – 2005/06 or 2006/07. However, most businesses will be able to pay this extra tax over three to six years.

When UITF 40 was first announced, many people thought it only really covered accountants and solicitors. In fact, many other business sectors will be affected if they perform service contracts over a period of time. For example doctors, dentists, architects, builders, letting agents, independent financial advisers, IT consultants, even farmers may have to recognise some of their income at an earlier stage – and the new practice applies to limited companies as well as partnerships and sole traders.

You cannot ignore the new accounting practice – HMRC will see to that – but you can lessen its financial impact. For example, regular billing and progress payments will ensure that the cash is there to pay the additional tax. And good accounting systems will prevent you overvaluing your income brought into account. Please contact us to discuss the implications for your business and how we can help.

BRONSENS

Oxford Office
26, Beaumont Street, Oxford OX1 2NP
Tel: 01865-552996. Fax: 01865-404090
Email: oxford@bronsens.co.uk

Chipping Norton Office
Hillside, Albion Street
Chipping Norton
Oxfordshire OX7 5BH
Tel: 01608-642051. Fax: 01608-641702
Email: chippingnorton@bronsens.co.uk

Partners: - Judith Borsay
- Phil Burton
- Barry Sennett
- Mark Winks

www.bronsens.co.uk

B.K.S. Payroll Services Limited
(Bookkeeping & Payroll Services)
Contact: Shirley Furze
Tel: 01608-649333. Fax: 01608-641702

Appeal Court rules on Arctic Systems test case

'Husband and wife' companies are safe from attack under the anti-avoidance 'settlements' legislation, the Appeal Court has ruled in the key Arctic Systems test case. Unanimously overthrowing the High Court verdict, the Appeal Court judges dismissed every plank of the Revenue and Customs case.

Geoff and Diana Jones both held shares in Arctic Systems Ltd, an IT consultancy, and received dividends. The High Court had ruled that dividends paid to Mrs Jones should be taxed as part of her husband's income because it was Mr Jones who generated the company's income and he drew only a small salary. These factors gave the arrangement an element of bounty, which brought it within the obscure settlements rules.

The Appeal Court said there was no 'settlement', firstly because Mrs Jones had paid full value for her shares, and secondly because there was no obligation for Mr Jones to work for a low salary, or indeed to work at all, and no guarantee of profits or dividends. Furthermore, Mrs Jones did contribute to the business, spending around five hours a week on book-keeping, invoicing, etc. Even if Mrs Jones had not paid for her shares, there

Continued on back page

In This Edition

- Pensions Controversies
- Pre-Budget Report News
- IHT Developments
- Pensions A-Day Arrives
- Research and Development Credits
- Small Firms Loan Guarantee Scheme

Pensions controversies

Can the country afford a higher basic state pension and is it fair to raise the state pension age across the board, when many manual workers have a life expectancy of little more than the proposed pension age of 68? These were some of the controversies raised by the publication of the widely-discussed Turner Report on long-term pension provision.

The report, which runs to 460 pages, covered more than state pensions and the controversial pension credit. It addressed the difficulties faced by private sector pension schemes, especially the reining back of final salary schemes and the growing cost of providing for an ever-lengthening period of retirement for some employees.

Recognising that some individuals provide for their retirement by putting their money in property and other non-pension investments, the report rejects compulsory pension saving. Instead it proposes a low-cost nationally funded pension savings scheme. Employees with no other pension provision would be enrolled automatically, but would have the right to opt out.

Members of the proposed scheme would contribute at least 4% of their earnings above a threshold of (currently) £94 a week, with a further 3% from employers and 1% from a scheme-specific tax relief. In effect, therefore, this would be a compulsory employer's pension contribution for any employee who did not opt out. The report suggests that this would secure a pension of around 15% of earnings for individuals who join early enough in their working lives. Investment fund choices would be limited in order to keep costs down.

The report also proposed that the state second pension, S2P, should move towards a flat-rate system instead of being based on earnings within a set band. The aim would be for the state system to prevent poverty rather than provide an earnings-related pension. The entitlement to the basic state pension should simply be based on a person's residence rather than their (or their spouse's) national insurance contributions record. Means testing, especially the pension credit, should be reduced, because it discourages private saving.

How much of the Turner Report the government will take on board is hard to guess. What is clear is that currently the only way to achieve the income you want in retirement is to take responsibility for your own savings and make your own choices.

Pre-Budget Report news

The Chancellor's change of heart on pensions investing in residential property hogged many of the headlines, but there were other – and important – announcements in the December 2005 Pre-Budget Report.

Company tax

Owners of small companies – those with annual profits below £50,000 – should carefully plan the timing of their dividend payments this spring. In his Pre-Budget Report in December, Chancellor Gordon Brown announced the end of the 0% tax rate on the first £10,000 of company profits from 1 April. He also abolished the complex rules that ensure small companies pay 19% tax on profits paid out as dividends to individuals and other non-corporate shareholders. From 1 April, small companies will pay 19% on all their profits.

Paying dividends *before* 1 April 2006 could increase your company's corporation tax, depending on its profits and recent dividend history. In contrast, paying dividends *from* 1 April 2006 will not affect its corporation tax liability.

You should also consider your personal income tax position as a shareholder. In some circumstances, your extra income tax could turn out to be more than the corporation tax saving. Ask us when you should be making your dividend payments. There are three main choices:

- Before 1 April – when the current corporation tax rules apply and your income will be taxed in 2005/06;
- Between 1 April and 5 April – when the new corporation tax rules apply but your income will still be taxed in 2005/06;
- After 5 April – when the new corporation tax rules apply and your income will be taxed in 2006/07.

The reason for the end of the 0% tax rate was, of course, the rush of tax-driven incorporations by sole traders and partnerships when it was introduced in 2002. So should you now stop trading as a company and become a sole trader or partnership? This could be worthwhile for some people, but for others a company still has advantages. The decision will depend on your own circumstances; please discuss it with us.

Capital expenditure

Other aspects of the Pre-Budget Report were better news for business. Small businesses – companies, partnerships and sole traders – will benefit from an increase in the first-year capital allowance from 40% to 50% for one year from 1 April 2006 for companies and 6 April 2006 for partnerships and sole traders. So it might be worth delaying major equipment purchases until then.

Work in progress

Businesses that provide contractual services will be able to spread the one-off extra tax charge on unbilled work, arising from the implementation of a new accounting practice known as UITF 40. Spreading will be over three to six years. We will make sure you get the maximum benefit from this concession, which follows extensive lobbying by accountants, lawyers and others.

Continued on back page

IHT developments

HM Revenue & Customs (HMRC) have been trying to tighten the conditions for claiming the valuable inheritance tax reliefs on agricultural and business property and two recent tribunal decisions have supported their efforts.

Agricultural property The agricultural property relief case concerned a farmhouse. Normally farmhouses qualify for 100% relief if the occupier is engaged in farming and the house is of a size and nature appropriate for the farming activities. The amount of relief is based on the house's agricultural value rather than its worth on the open market and it is this point that led to the dispute. Revenue and Customs argued that the open market value of the house in question was greater than its agricultural value and denied inheritance tax relief on the excess. The Lands Tribunal ruled that the agricultural value was only 70% of the open market value.

The decision leaves owners of farmhouses potentially exposed to more inheritance tax than they might expect. However the difference between agricultural and market value can vary and depends on local market conditions and the nature of the house, for example how attractive it is as a non-agricultural property.

Business property relief Shares in an unlisted company qualify for 100% business property relief if the company carries on a business. However, a business that consists mainly of holding investments does not qualify. The Special Commissioners were asked to decide the status of a company that owned, managed and maintained 241 properties. The maintenance activities were significant and this business might have allowed the company's shares to qualify for relief. But when the Commissioners analysed the figures, they found that the management and maintenance side of the business made a loss and was totally supported by the investment activity of receiving rents. As a consequence, relief was denied.

Civil partnerships There is better news for same-sex couples, who now enjoy the same inheritance tax planning opportunities as married couples if they register as a civil partnership. Civil partners can pass assets to their partner free of inheritance tax both during their lifetime and on death. And the less well known exemption for wedding gifts now extends to civil partnerships. Parents can make tax-free gifts of up to £5,000 and there are lesser exemptions for other donors.

Pensions A-Day arrives

There will be major changes to the tax rules for pensions from 6 April this year, which has been designated A-Day by HM Revenue & Customs (HMRC). Contributions will still qualify for full tax relief and pension funds will grow largely free of UK tax. Otherwise, the changes will be radical and will include the following:

- Today's eight different sets of rules for different types of pension arrangement will be replaced by one new set of rules that will apply to all pension schemes.
- Your pension benefits will be subject to a lifetime allowance, initially £1.5m. This will effectively set an upper limit on the value of tax-efficient pension benefits that you can have.
- The current limits on the amounts you can contribute to your pensions will disappear and instead you will have an annual allowance, initially of £215,000. Your maximum effective personal contribution to pension arrangements will normally be 100% of earnings.
- As a general rule, you will be able to draw a quarter of the value of all your pension arrangements as a tax-free lump sum.
- You will not have to buy an annuity by age 75, but you must draw any tax-free lump sum before then.
- There will be new rules restricting borrowing by pension schemes. However, following a change announced in the Pre-Budget Report, investment in residential property and assets such as fine wine and antiques will be heavily penalised.
- The minimum age at which you can normally draw your retirement benefits will rise from 50 to 55 on 6 April 2010.

The new rules are accompanied by a raft of transitional reliefs, which will generally protect you from any tax penalty on actions taken or funds built up before A-Day. Some of these reliefs are given automatically, while others must be claimed.

Whatever pension arrangements you have – or even if you have none – simplification means that you should arrange for a review of your retirement planning. The new rules open up many new opportunities, but also call into question some traditional ideas.

For example, if you are a private company shareholder/director, from April you might find it makes more sense to contribute to a self-invested personal pension (SIPP) rather than a small self-administered scheme (SSAS). At present the SSAS is more attractive because the contribution limit is normally higher, but from A-Day this difference disappears.

Not everyone will be necessarily better off under the new pension simplification rules. You might find that from A-Day it will not make financial sense to contribute to a pension plan. For that reason, if for no other, you should talk to us before making any pension contributions after A-Day.

Research and development credits

The government has paid out more than £850 million of support to over 16,000 small and medium companies in the form of research and development (R&D) tax credits since the scheme started in 2000. A survey among companies carrying out R&D found that the tax credits had enabled a third of them to take on projects with a longer pay-off time and nearly a quarter had taken on more risky projects.

The scheme gives small and medium businesses tax relief on 150% of qualifying expenditure on R&D. You need only spend £10,000 on research and development in an accounting period in order to claim – and a wide range of projects can qualify. Very broadly, projects qualify if they are intended to increase scientific or technical knowledge, or to create or improve a process, product or service through scientific or technical advances. Expenditure has to be on staff costs or on consumables used directly in carrying out R&D. Capital expenditure does not qualify, although there is a separate 100% capital allowance for equipment used in R&D.

Large companies can only claim 125% and there are several other differences in the rules.

If you are carrying out R&D, or are not sure, do ask us about tax credits.

TAXATION

Arctic Systems test case

Continued from front page

would be no settlement because a share is not merely a right to income. The settlements provisions cannot extend to a commercial venture of this type between husband and wife.

HMRC was refused leave to appeal to the House of Lords, but will seek leave to appeal direct. In the meantime, HMRC will not update its guidance to taxpayers based on the High Court ruling, but this does not have statutory force. The government could also change the rules by legislation, so watch this year's Budget.

For the moment, tax planning for family companies has been given a new lease of life, though it is important to take care, as HMRC might try to attack arrangements that differ in some details from those in Arctic Systems. However in many cases, where both spouses own and receive dividends on shares, each should now be taxed on the dividends they receive.

If dividends paid to one spouse were included on the other spouse's 2004/05 tax return, both returns can now be amended so that each spouse is taxable on their own income on the basis of the Appeal Court verdict. Please contact us if you would like to discuss the implications of this decision on your business.

Small firms loan guarantee scheme

New businesses will be able to raise more finance under the government's small firms loan guarantee scheme after changes to the criteria from 1 December 2005. The scheme guarantees loans from banks and other lenders to small businesses that have a viable business proposal but lack security. In another change to the rules, the business must be less than five years old.

If you have a business with a turnover up to £5.6 million, you can now borrow up to £250,000 for between two and ten years. You will be evaluated on the quality of your business case rather than your own individual borrowing history. The government is encouraging high street banks and a range of specialist lenders to make loans available under the scheme.

The scheme guarantees 75% of the loan. In return, as the borrower, you must pay the Department of Trade and Industry a premium of 2% a year on the outstanding amount of the loan. This is in addition to the interest you pay on the loan at a rate fixed by the lender. Many business activities are eligible but there are a number of exclusions.

If you are interested, you have to apply to one of the approved lenders, which include all the major banks. Your business will need to satisfy the lender's commercial criteria and demonstrate that it can repay the loan. You will need a clear business plan and financial forecasts to demonstrate the viability of your proposal and to identify your need for finance. We can help you prepare these.

Pre-Budget Report news

Continued from page 2

VAT

Businesses with turnover up to £1.35 million will be able to make annual, instead of quarterly, VAT returns. This reduces administration, but can be a two-edged sword if it means VAT liabilities and paperwork mount up and it could reduce your cash flow.

You could find that the matching increase in the turnover limit for cash accounting to £1.35 million is more useful. That means paying VAT only on the cash payments you receive rather than all invoices you send out – though this is subject to the European Commission's agreement.

This newsletter is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking any action on the basis of the contents of this publication. The newsletter represents our understanding of law and HM Revenue & Customs practice as at January 2006.