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Incorporation – is it still worthwhile?

Zero per cent corporation tax is no more, meaning that the tax savings from incorporating a business are smaller. Trading as a limited company still offers benefits – it's just that the decision is now less clear-cut and you must consider the pros and cons carefully.

Incorporation can still save you money because you can avoid national insurance by paying yourself mainly in dividends. For example, turning a small business with profits of £50,000 into a company could increase the owner's net income by over £4,000 a year. Even at lower profit levels, there are still worthwhile savings.

Doing business via a company has other advantages. Above all it gives you limited liability, helping to protect you from many business risks – though not those involving your personal guarantees. Companies are also often easier to finance, especially as they get bigger.

You could appoint directors who are not shareholders, or give shares or share options to employees to give them a stake in the growth of the business, although you need to be careful about the tax issues. Giving shares to family members could save tax on dividends and tax on the capital gain if one day you sell the company. However, there are some complicated tax issues that mean you should get competent advice when setting up the company share structure.

But there are some drawbacks. Administrative costs are usually higher than for self-employment and companies must file accounts at Companies House, although small companies can file abbreviated accounts to minimise their exposure. Incorporation results in some loss of flexibility and company owners may find it difficult to accept that they are not free to draw on the company's bank account without going through certain formalities.

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Tax changes affect wills and trusts

All existing trusts and all wills that create a trust should be reviewed in the light of fundamental tax changes introduced in the 2006 Finance Bill. New inheritance tax charges on most trusts will not immediately hit arrangements that were already in existence on Budget Day – 22 March 2006. But many people will want to change their wills as a result.

The Finance Bill will impose the discretionary trust inheritance tax regime on most new trusts. Lifetime transfers into trusts will be liable to 20% inheritance tax if they exceed the nil rate band, £285,000. There will also be a periodic tax charge of up to 6% every ten years and an exit charge when property is removed from the trust, in most cases to the extent that the value of the trust assets exceeds the nil rate band at the time.

One type of trust affected is the accumulation and maintenance trust (A&M). These trusts are commonly used to pass wealth to children and grandchildren free of inheritance tax while retaining some control while the beneficiaries are young.

Under the current draft legislation, existing A&M trusts will come within the new rules on 6 April 2008, unless they provide for the assets to go to beneficiaries absolutely at age 18. New A&M trusts created on the death of

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Tax saving tips for company car drivers

At one time, company cars were highly tax-efficient perks. Successive tax increases mean that those days are long gone, but a company car can still be a useful benefit for employees and directors – at least in some circumstances. You need to weigh up several factors, such as the amount of private and business mileage, the car's price and emissions rating and the salary alternative offered.

Vehicles that are classified as vans still involve a very low tax liability for private use, but the tax on them is due to rise in the tax year 2007/08, making them less attractive.

Providing employees with fuel for private use of company cars is rarely worthwhile because it attracts a high additional tax charge. It is usually better for employers to pay employees a mileage rate for their business travel.

HM Revenue & Customs (HMRC) publishes advisory rates that employers can pay employees to cover the fuel costs in their company cars and has said that no tax charge will arise where employers pay these rates. But higher rates are allowed where the employer can show that the actual cost of fuel for the car concerned is greater. Using the advisory rates is simpler but with rising fuel prices, it is worth reviewing the position.

For example, the advisory rate for a petrol-driven car of over 2,000cc is 16p a mile, but it could be worth claiming 19p a mile for a car consuming at the rate of five miles per litre and at, say, 95p a litre.

Employers who reimburse business fuel and wish to claim the VAT input tax must have VAT invoices that at least cover the amount claimed. The VAT procedures changed with effect from 1 January 2006, and employers should now retain VAT invoices, including less detailed VAT invoices from fuel suppliers as proof of purchase.

Employers can recover VAT input tax on the other costs of running company cars, such as repairs, but not on the purchase price of a car that is available for a director's or employee's private use. HMRC normally argues that all cars provided to employees may be used privately, except for pool cars where private use is prohibited. However, the High Court recently allowed a claim for input tax on a car provided to its sole director where the company had minuted a resolution prohibiting private use and there was a genuine intention to use the car only for business. The car keys were kept in the company's office and the car in a car park nearby, although this was also very near the director's home. The decision may go to appeal, but at the moment the way is clear for input tax recovery on company cars, although in rather exceptional circumstances.

For the employer, capital allowances for the purchase of company cars costing over £12,000 are restricted to £3,000 a year, but there is one exception. The full cost is allowed immediately where a business buys a new car that has CO_2 emissions of no more than 120 grams per kilometre. Although few cars meet this condition, the variety is increasing. These cars also attract the lowest level of car benefit tax for employees.

Deciding whether to provide or accept a company car and putting together the right package can be complicated and the tax involved can be considerable, so it is worth asking for advice in this area.

Helping to make your payroll run smoothly

New employees should stand a better chance of having the right amount of PAYE tax deducted from their first pay packets following changes to the procedures for allocating tax codes to new employees without a P45.

Employers can now use the emergency tax code (currently 503L) cumulatively where employees certify that they have not had a job since the previous 6 April or received any taxable benefits. This allows employees to have their personal allowance for the whole period since 6 April on their first payday, instead of just the proportion for the time for which they are paid.

The new form P46, which employees without a P45 must complete, also asks whether the employee has any outstanding student loan repayments. If the employee ticks the box and earns at a rate of more than £15,000 a year, the employer must make deductions immediately instead of waiting for a notice from HM Revenue & Customs.

In another change, employers no longer have to pay national insurance contributions (NIC) on payments by employee-operated troncs, even if the entitlement to a share of the tronc is part of the employment contract. Restaurants and some other businesses use troncs to pool and distribute tips, but the tax treatment is complicated and it is important to take great care with them. Tips distributed through the payroll remain liable to NIC.

Student loan deductions and frequent changes in procedures are just two of the factors that can give rise to mistakes in calculating the correct PAYE tax and national insurance. Even if you use payroll software, it is essential to input correct and complete details. Many organisations find that outsourcing their payroll compliance and administration lifts a significant burden and allows them to focus on their core activities. Please let us know if you would like further information.

Tax-free employee benefits that survive

One of the big surprises of this year's Budget was the sudden ending of the home computer scheme for employees on 6 April 2006, especially after the Department of Trade and Industry had done so much to promote the home computing initiative. Computers provided to employees before 6 April 2006 remain exempt, provided the value of the equipment was not more than £2,500.

Employers can still provide employees with computers for business use, for example if employees work at home or need a laptop for use on business trips. There is no tax or national insurance charge if the computer is provided solely for business use and there is little or no private use – so not too many personal emails!

In another cut, employees will only be able to have one tax-free mobile phone supplied by their employer. They will now be liable to tax on mobile phones provided by their employer apart from the first one. Until 5 April 2006, employers could provide any number of phones to employees and their families and pay the cost of all calls, without any income tax or NIC charge. Phones provided before 6 April remain exempt until replaced.

Remember that the tax exemption only covers a phone that the employer provides. If the employer pays the employee's own bills for buying a mobile phone or making calls from it, the private element is subject to both income tax and national insurance contributions.

One exemption that emerged unscathed from the Budget is for bicycles lent to employees. Bikes and cyclists' safety equipment are exempt if they are offered to all employees and used mainly for journeys to work, between workplaces or in breaks from work. Employees do not have to keep detailed records of use. The exemption also covers the provision of a voucher for hiring bicycles and equipment.

Employees who use their own bicycle for business travel can claim a tax-free 20p mileage allowance, though not for cycling to work.

Family companies – how to protect yourself against Revenue attack

HM Revenue & Customs (HMRC) will challenge an Appeal Court decision that dividends paid by a family company to a non-working spouse cannot be taxed as the working spouse's income – the infamous Arctic Systems case.

It is likely to be several months before the House of Lords hears the case, leaving many couples uncertain as to how much tax to pay.

If the Lords decide in favour of HMRC, taxpayers whose assessments are 'on hold' pending the decision will be liable to additional tax plus interest. HMRC may also open new enquiries into the tax affairs of people in a similar situation.

One way you can protect yourself against interest and penalties on tax paid late in such circumstances is to buy certificates of tax deposit. This allows you to pay the potential additional tax on time without drawing HMRC's attention to the fact that you think your self-assessment might be inadequate.

If after an enquiry you use the certificate to pay additional tax, the tax is treated as if you had paid it on the due date for payment of the tax, or on the date you bought the certificate if that is later than the due date. If it finally turns out that you do not need the certificate to pay the tax, you can redeem it with interest.

Revenue's wholesale trawl of offshore bank accounts

HM Revenue & Customs (HMRC) has stepped up investigations into people with offshore bank accounts. The crackdown follows the implementation last July of the European Union Savings Directive, which allows EU states and some offshore territories including Jersey, the Isle of Man and Guernsey to exchange more details about bank accounts.

Last year around 500 individuals received letters from HMRC asking them why they thought they were not liable to tax on their offshore bank interest. Individuals who are resident and domiciled in the UK are taxable on investment income wherever in the world it arises. Those who are resident in the UK but domiciled elsewhere are liable to tax on overseas investment income, but only if they bring it into the UK. Anyone who does not disclose all their interest in reply to such a letter is likely to face a full enquiry, often by a specialist HMRC investigation office.

Under the European Savings Directive, individuals with offshore bank accounts must either suffer a withholding tax, currently 15%, or agree to the exchange of information.

Whichever is the case, you must declare overseas interest on your UK tax return unless you are not domiciled in the UK and do not remit the income. If you receive one of these letters from HMRC, please let us know immediately.

BUSINESS

Age discrimination deadline October 2006

Age discrimination will be against the law from 1 October 2006. With some exceptions, employers will no longer be able to use age-related criteria in recruitment, selection, promotion and entitlement to benefits, nor will they be able to force employees to retire at a specified age.

The government has now published the final draft regulations, which lay down much of the detail of how the legislation will be applied. Employers will not be allowed to set a compulsory retirement age below 65 unless they can justify it objectively. Where an organisation sets a compulsory retirement age, employees will have the right to ask to continue working beyond that age and the employer must consider the request seriously. The regulations establish a set procedure for employees who want to continue working beyond 65 and if employers follow this procedure, employees will not have a case for unfair dismissal where the dismissal is on retirement grounds.

The regulations also cover recruitment, redundancy, pay and benefits, and include a number of other changes since the first draft. Employers will need to make sure that all their procedures will comply with the new law, otherwise they could face some potentially expensive claims from employees, prospective employees and even some self-employed contractors.

LAW

Buy-to-let costs soar

Student landlords and other owners of houses in multiple occupation may have to obtain a local authority licence or risk a fine of up to £20,000. The licence will specify the minimum standards that the accommodation must meet and can require the landlord to carry out specified improvements some of which could turn out to be expensive.

The mandatory licence scheme came into force on 6 April and covers houses with three or more storeys that are occupied by at least five people who form two or more households. Some local councils may impose licensing on even smaller houses. Students who occupy separate rooms generally each count as separate households.

Local authorities are free to set the fee and some are charging as much as £1,100 for a licence for up to five years. The fee is normally tax deductible from letting income, but this is not necessarily the case for the costs of any work required on the property. The general rule is that repairs are deductible, but improvements, extensions and expenditure on furniture and equipment are not. For example, creating en-suite facilities where there were none before, or installing central heating and additional toilets are not allowable deductions for tax purposes.

Landlords of furnished accommodation can claim one of two allowances. The simpler one is the wear and tear allowance of 10% of the net rent – rent less any water rates and council tax paid by the landlord. Alternatively, landlords can claim a renewals allowance for the actual cost of replacing items such as movable furniture, carpets and curtains, but not the initial cost of providing them. All landlords, including those claiming the wear and tear allowance, can deduct the cost of renewing landlord's fixtures, such as bathroom suites – but not any improvement element.

The new licensing requirements may make letting of some properties in multiple occupation uneconomic. We can advise on your tax position and calculate the projected return on your property investment taking into account the income, expected capital appreciation and costs, and help you decide whether it is worthwhile.

VAT on internet sales from Jersey

The Jersey government has said it will crack down on traders who use the island to avoid VAT on internet sales of low-value goods such as CDs, DVDs and health foods. Under EU law, traders outside the EU do not have to charge VAT when they sell goods valued at less than £18 to EU customers. Several internet traders have set up Jersey-based operations for that reason, but the Jersey government believes that negative publicity has damaged the island's reputation.

Businesses that buy stock in Jersey and hold it there before sale will not be affected, but businesses that are in reality based in the UK will be given a year to cease operations. Some retailers have indicated they will switch their activities to other states with similar tax regimes, such as Guernsey. There have been no moves within the EU to end the VAT exemption for low-value goods and there is some scepticism about whether the Jersey government will maintain its stand.

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a parent will also escape ten-year and exit charges provided the child becomes entitled to the assets at 18, a condition that will cause concern in many families.

The tax changes also have an impact on provisions in a will that give a surviving spouse an income but pass the capital to the children after the second spouse's death. This is because the inheritance tax exemption for assets passed to a spouse or civil partner will no longer apply to such arrangements.

Contrary to initial fears, it seems that the proposed changes will not put an end to many insurance-based inheritance tax planning schemes. Insurance companies withdrew several plans after the Budget, but many are now back on sale, although some are less flexible than they used to be.

We strongly advise all clients to review their wills, inheritance tax planning and any interest in an existing trust, once the legislation is clear in July, to assess the impact of the changes and what action can be taken.

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 May 2006.