NEWSLETTER • SUMMER 2003

BRONSENS

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Radical New Pensions Rules

Retirement financial planning will change radically, especially for high earners, if the government's proposals to shake up the pensions tax regime become law. So it is important to make the most of your opportunities for this year under the present rules, while looking ahead towards the changes.

High earners will be affected by the limit of £1.4 million, index-linked to prices, on the value of any individual's tax-exempt pension fund. Any excess above this limit when benefits are drawn will be taxed at 33⅓% before being used to provide taxable benefits. This means an effective tax rate on excess funds of up to 60%.

Funds worth over £1.4 million when the new rules come into effect – possibly 6 April 2004, more likely a year later – will be protected from this double tax charge. If your fund is near or over this limit, it makes sense, from a tax perspective, to pay in as much as possible now. This might also be your last chance to make significant tax-exempt pension contributions, because your scope for further tax efficient contributions under the new rules may be minimal.

If, like most people, the value of your fund is well below £1.4 million, you might benefit from the proposed removal of the present limits on contributions. But it would be unwise to put your pension payments on hold until then. If you do not invest in your pension now, it will probably cost you more to obtain the same benefits later on.

Many people who aim to retire early will be disappointed by the proposal to raise the minimum age at which pension benefits can be drawn from the current 50 to 55, starting in 2010.

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Hidden Surprises in the Budget

At first sight, this year's Budget seemed to have few surprises. It was only when the professional commentators burrowed into the details of the Inland Revenue announcements that the key points started to emerge. Many proposals had been announced previously; the Budget filled in some of the details.

Individuals and trustees who let property to traders will benefit from the removal of an anomaly in the business asset taper relief rules. At present, a sale of property that is used in a business in which the owner is not involved may qualify for the lowest capital gains tax rates (in effect, a possible maximum of 10%) if the tenant was an unlisted limited company, subject to conditions. From 6 April 2004 the property may also qualify if the tenant is a qualifying individual trader or trading partnership.

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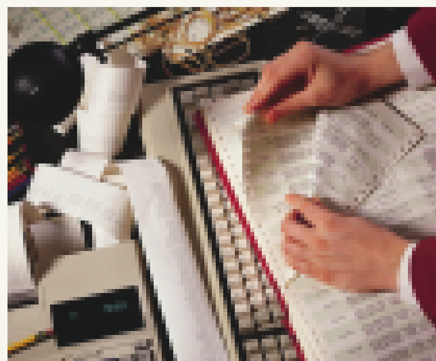
Taxation

Key Deadlines for Self-Assessment in July



Individuals taxed under self-assessment have to make their second payment on account of tax for 2002/03 by 31 July 2003, although some taxpayers are exempt from the requirement to make any payments on account.

If you have still not filed your 2001/02 tax return you should remember that a second fixed penalty of £100 will be charged if you do not make the return by 31 July. You could also lay yourself open to daily penalties of up to £60, although these are only charged in a few cases.

Selling a Subsidiary

Trading groups can sell a trading subsidiary free of corporation tax on chargeable gains under legislation that came into effect on 1 April 2002. The exception, which is subject to various conditions, even extends to shareholdings of at least 10%. The same is not true for a sale of a branch of a company. The assets and liabilities of a branch of a business are often hived down into a new company before a sale. However the sale of the new company will not be exempt from tax because it will not satisfy the condition that the shares were owned for at least 12 months.

Companies and groups contemplating the sale of part of a business need to plan well ahead to ensure they fall within the exemption for sales of such shareholdings. There are some pitfalls that can be avoided with forethought. Conversely if the disposal will generate a loss, it may be beneficial to make sure it does not fall within the exemption, so that the loss is available for relief against other gains.

Tax Credits Tangle

Claiming the new child tax credit has become a minefield, with new difficulties emerging all the time – especially for the self-employed.

The first hurdle is that claims cannot be backdated by more than three months. Claims for the year that began on 6 April 2003 are initially based on the claimant's income in 2001/02. If you did not claim child tax credit because your income for that year was more than £58,000 (£66,000 if you have a child under one year old), and your actual income for 2003/04 turns out to be lower, you will only receive tax credits for the three months up to the date you claim. The solution for people with fluctuating income is to make a claim regardless of your income level in 2001/02, just in case your 2003/04 income turns out to be low enough to qualify for the credit.

But making such a protective claim may not be enough, because you have to notify changes in income, compared to the year on which the initial claim is based, within three months of the change, unless the variation is £2,500 or less. The Inland Revenue will backdate by only three months any increase in tax credit entitlement as a result of falling income. In contrast, if your increased income means you have received too much tax credit, you will have to repay the difference for the entire period affected.

The next problem is that you have to verify your income for 2003/04 by 5 July 2004. This is nearly seven months before the self-assessment deadline of 31 January and allows the self-employed only three months to prepare accounts if their accounting date is 31 March. Even employees could have difficulty with this deadline, if the employer waits until the 6 July deadline to inform employees of their taxable benefits and expenses.

Establishing the amount of income for tax credit is also fraught with difficulty – it is not necessarily the same as taxable income. Certain forms of interest paid are deductible on a tax return but not in calculating tax credits. Carrying back trading losses for tax purposes does not count for tax credit purposes, but such losses can be set against a couple's joint income of the current year in a tax credits claim. Income tax trading losses of one partner cannot be set against the other partner's income.

Needless to say there are penalties for failures to notify and for providing incorrect information, although they will not be imposed automatically. Not surprisingly, it has been predicted that tax credits claims will become the main focus of Inland Revenue investigations.

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Husband and Wife Companies under Revenue Attack

The Inland Revenue is using complex tax avoidance legislation to attack a small number of family companies that pay dividends to a director's non-working spouse. The policy has provoked outrage not least because it leaves individual taxpayers uncertain about what is acceptable and what should be declared on their tax returns.

The type of company being investigated has husband and wife shareholders, little capital introduced into the company and a low asset value. The work in the business is carried out wholly or mainly by one spouse, usually the husband. Profits are paid out partly as salary and partly as dividends as a result of which the wife receives some income. In such a case, the Inland Revenue may argue that the income results from the husband's work and will aim to tax him on all or some of it. The result is usually that the wife's dividends become liable to higher rate tax. It seems to make no difference whether both spouses subscribed for the shares at the outset or whether the shares were transferred as a gift.

One way directors might be able to protect themselves from attack is by reducing the proportion of profits drawn as dividends. If the director draws a commercial salary, the Inland Revenue cannot attack the distribution of further profits as dividends to all shareholders. However the payment of a commercial salary increases the liability to national insurance contributions. Another move that might help could be to reduce the proportion of shares held by the wife, so limiting the dividends paid to her.

Whether the Inland Revenue is on firm legal ground is open to challenge, but in the meantime, it might be as well to exercise caution.

New Rules for Company Car Fuel

The new rules for taxing fuel for company cars came into operation on 6 April 2003, making it increasingly unattractive for employers to provide fuel for private mileage for larger cars. For 2003/04, the benefit on which the employee is taxed will depend on the car's carbon dioxide emissions and will range from £2,160 to £5,040, compared to a range of £2,240 to £4,200 last year. Employers have to pay national insurance contributions, now at 12.8%, on the same figure.

The fuel benefit is calculated by multiplying £14,400 by the same percentage (ranging from 15% to 35% and based on emissions) that is used to calculate the car benefit itself. For example, on a car with emissions of 195 grams per kilometre the percentage is 22%. Multiplying this by £14,400 gives a fuel benefit of £3,168. For many cars, this percentage is increasing each year because of annual reductions in the lower emissions threshold. (This is the amount up to which the percentage for calculating the tax charges is 15%.) It is also likely that the £14,400 multiplier will rise in future years.

Several tax and other factors have to be considered in deciding whether there is any advantage in an employer providing fuel for private mileage in a company car, or indeed in providing a company car at all. We can help you make the comparison and help you make whatever changes you decide upon.

PAYE E-Filing to be Compulsory

Employers with fewer than 50 employees are being given a £250 incentive to file their PAYE returns electronically for 2004/05. Financial incentives will continue up to 2008/09, after which electronic filing will be compulsory for all employers. E-filing by an agent or payroll bureau, as well as by the employer, will qualify for the payment.

Employers with 250 or more employees will have to make electronic PAYE returns from 2004/05, i.e. by May 2005, without any incentive other than the avoidance of penalties of up to £3,000 for failing to do so. They will also have to make their monthly PAYE payments electronically by April 2004.

We can help you if you are concerned about these requirements.

Working From Home—Tax Breaks

Employers can now make payments towards the additional household costs incurred by employees who work at home without creating an income tax liability for the employee. Until this change was announced in the Budget, the Inland Revenue had been adamant that such payments would be taxable if the employee worked at home by choice rather than because it was a requirement of the job.

The concession is far from generous. Employers will be able to pay up to £2 a week without supporting evidence. For payments above this level, the employer must obtain evidence of the actual additional costs incurred by the employee, such as extra heating, electricity and internet access.

Self-employed people working at home have always been able to deduct the related costs in calculating their taxable business profit, although the Inland Revenue might argue over the amount.

Another issue is whether running a business at home creates a liability to business rates. The Inland Revenue Valuation Office website states that business rates can be charged on the use of a home as an office, even where no part of the property is used exclusively for business. But the Institute of Chartered Surveyors takes the view that intermittent business use of a residence should not trigger a rates charge.

In practice, most rating authorities do not seek to impose liability where a business is run from home unobtrusively, but they might take action if business use is extensive, for example if there are employees, a lot of parked cars or frequent visits by customers and clients. It has also been suggested that incorporating a business could bring it to the attention of the rating authorities.

Investment

Offshore Investments Warning

Earlier this year, it emerged that the Inland Revenue was investigating people with bank accounts in Ireland, following information received from the Irish tax authorities. It is a fairly common misconception that offshore income is not taxable in the UK. In fact taxpayers who are resident and domiciled in the UK must declare all their income, wherever it arises. Tax authorities do exchange information and failing to declare income will lead to penalties and interest on the tax paid late.

UK residents can legitimately defer tax by investing in offshore bonds or offshore roll-up funds that offer gross roll-up of interest. Gains are reinvested and tax is not payable until the bonds are encashed. It is important to ensure that the costs of investing do not outweigh the possible tax advantages.

Employment

Coping with Flexible Working

Employees with children under six years old now have the right to request flexible working arrangements and employers must take such requests seriously. This right is extended to parents of disabled children below the age of 18. Flexible working can cover family-friendly hours and even working at home where practical.

There is a set procedure, with time limits, to which employees and employers must adhere. The employer must hold a meeting with the employee and employees have a right of appeal against the employer's decision. An employer can only refuse an application if there is a clear business reason for doing so.

Parents of babies born after 5 April 2003 also have increased maternity or paternity rights.

• Fathers can take up to two weeks' leave, which have to be taken in one block within 56 days of the birth. Provided the employee earns enough, he also qualifies for paternity pay of up to £100 a week.

• Mothers may now qualify for up to 52 weeks' maternity leave. The first six weeks may be paid at 90% of the employee's average earnings and the next 20 weeks at up to £100 a week. Paternity and maternity leave are in addition to unpaid parental leave of 13 weeks for looking after a child, which can be taken up to the child's fifth birthday.

There are various qualifying conditions and employees have to notify the employer in the correct form of their intentions to claim maternity or paternity leave and pay. Also new from 6 April 2003 is that adopting parents have similar leave and pay rights as parents of newborn babies.

Don't Fall Foul of Data Protection

Employers should take care not to fall foul of the Data Protection Act in dealing with employees. The first two parts of an employment practices data protection code published by the Information Commissioner give extensive guidance on how the Act should be interpreted in matters of employee records and recruitment.

Data protection rules cover nearly all the usable information that an employer might hold about individual workers, including casual and agency staff, regardless of whether the data is held electronically or on paper. The code explains what personal information an employer should hold and for how long, how data should be managed, the need to inform the employee about any data held, the rules on disclosing data to third parties and the employee's right to access information.

Recruitment advertisements and application forms should include an explanation of how the applicant's details will be used. The information requested should only be relevant to the recruitment process, and candidates should be informed what tests and checks might be undertaken. Interview notes and documentation for unsuccessful candidates must be retained and only destroyed after one year. The data protection rules are in addition to the anti-discrimination legislation that also governs the recruitment process.

Budget Changes

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Unfortunately, only periods of occupation after 5 April 2004 will count. This means that if you already own a property which you let to an individual or partnership, you will normally need to wait another ten years before selling it if you want the whole gain to benefit from the lowest tax rates. There is some scope for restarting the taper relief period so that the lowest tax rates are reached after a further two years of ownership, but the required arrangements can have disadvantages.

Another significant capital gains tax change eliminates a problem that sometimes arises on the sale of a business where the final price is left to be determined at a later date, usually as the result of an earn-out. In such deals, the seller has to pay tax on the current value of the right to receive further consideration. If it turned out that the seller received less than this amount, there was previously no revision to the original tax liability. Now the seller's 'loss' can be deducted from the original gain, subject to a number of conditions.

Single premium bonds – non-qualifying life assurance policies – may be subject to higher rate tax when they are encashed by 40% taxpayers. From 6 April 2004 the rate of tax charged is due to rise from 18% to 20%, reflecting a small reduction in the tax on the underlying funds.

Prevention of avoidance of tax, including VAT, featured strongly in the Budget. Perhaps of greater interest than the changes were the rules that stayed the same. For example, it remains beneficial from a tax viewpoint to trade through a limited company rather than as a self-employed individual or partnership. But nannies and some others who supply services to private individuals rather than to businesses can no longer gain a tax advantage by operating in this way.

Tax Credits Tangle

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Many families will only be entitled to the basic child tax credit of £545 and may decide that claiming it is not worth the time and effort, especially if they are self-employed. For those who do claim, a change of accounting date to 30 April might be helpful, although such a move is likely to result in some of their income being taxed twice.

This newsletter has been written for the general interest of our clients. It is therefore essential to take advice on specific issues. We believe the facts are correct as of June 2003 but there may be certain errors and omissions for which we cannot be held responsible.