business UPDATE

Winter 2008

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Where There's a Will…

If you don't make a will, you could end up leaving your relatives with serious problems after your death. Dying without a will increases the complexity and time involved in dealing with your estate. And the resulting uncertainty or disagreements between relatives can sour family relationships.

If a person dies intestate – without a will – the law will determine who inherits what. Many people believe that all their assets will automatically go to their surviving spouse or civil partner, but that is only the case for small estates. Since 1993, the statutory legacy that a surviving spouse (and nowadays a civil partner) can inherit in England and Wales has been set at £125,000 where there are surviving children and £200,000 otherwise.

The Government recently announced that these limits will go up to £250,000 and £450,000 from 1 February 2009. While this will give extra protection to surviving spouses and partners, it will not ensure that your estate is distributed how you would wish. There will still be cases where a family home has to be sold to enable children or other relatives to inherit their share of an estate under the intestacy rules.

The intestacy rules are different in Scotland. A surviving spouse who lived in a house owned by the deceased has a prior right to the home up to a value of £300,000 plus specified amounts of other assets. In Northern Ireland, the limits have been £250,000 and £450,000 since 1 January 2008.

The need for a will is even greater for people who live together without getting married or registering a civil partnership. If one partner dies intestate, their estate will pass to their family, with the only exception being their house if the couple owned it jointly.

Another very good reason for writing a will is to make sure your estate is distributed tax-efficiently. Operation of the intestacy rules may result in more inheritance tax than necessary being paid on the intestate's death or on a subsequent death.

Even if you already have a will, your circumstances and tax legislation may have changed. If you have no will, or have one but have not reviewed it recently, or want to minimise inheritance tax on your estate, please ask us for advice.

Charity Accounting

Allotts are pleased to announce that Partner Jackie Saunders and Senior Manager Mark Garrison have recently been awarded the ICAEW Diploma in Charity Accounting (DChA). This is the new qualification for people who have demonstrated a high level of competence in charity accounting and financial management.

The firm currently acts for around 50 charities in the South Yorkshire area, some very large and some much smaller. You may be familiar with some of them. Acting for charities is a specialist area as they operate under different regulations from commercial entities. Accordingly we decided to take the opportunity of acquiring a nationally recognised qualification to demonstrate our expertise.

Allotts has been a member of CharterGroup, a network of quality independent accountancy practices spread across the UK, since 1986. CharterGroup have recently launched a charities special interest group which enables us to pool experience and ideas to promote ourselves and our expertise more widely.

We are always keen to have the opportunity to meet with potential new clients and would welcome introductions to charities for which we do not act. Please refer us to any charities with which you are involved, and which you feel would benefit from a professional approach from highly experienced individuals.

Jackie and Mark can be contacted at our Rotherham office on 01709 828400

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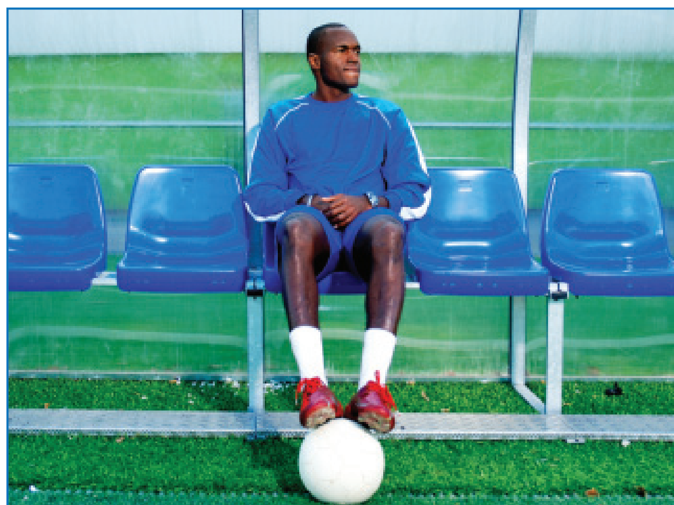
tax ISSUES

No Substitute for Dragonfly on IR35



If you provide services through an intermediary company and think you are protected from the so-called IR35 rules, you may need to look at your arrangements again. A recent decision in the High Court has made it easier for HM Revenue & Customs (HMRC) to ignore a 'substitution clause' in a contract if, in practice, substitution would not happen.

Although there are many factors to consider, a strong indication that an engagement is not akin to employment is a contractual right for the intermediary to send a different individual to do the work. Until the Dragonfly Consulting Ltd case, many people thought that the presence of a substitution clause was nearly conclusive in taking income outside IR35. The court made it clear that other elements are significant, in particular, the extent to which the client would allow substitution in reality. In the Dragonfly case, the client company wanted the services of the particular individual, a skilled IT system tester, and the manager said substitution would not happen in practice.

A complication in this case was that Dragonfly provided services through an agency, so there were two contracts. The 'lower contract' between Dragonfly and the agency contained a substitution clause, but the contract between the agency and the client did not. This 'upper contract' is usually outside the control of the worker, who often is unaware of its terms. This fact, coupled with the need to find out what the client would allow in practice, makes it very difficult for the worker to decide up front whether income falls within IR35. And it is difficult to argue against a ruling by HMRC that it does.

If the ultimate client wants the services of a particular individual, it now appears to be very difficult to put in place contracts that take the arrangement outside IR35. This leaves the worker having to suffer the full tax and NICs equivalent to an employee without the protection that employment legislation would provide if he or she were employed directly by the client or even by the agency.

If an arrangement is otherwise indicative of self-employment, then the lack of a clear substitution right is unlikely to be decisive. If you would like to discuss this issue with us, please get in touch.

Entrepreneurs' Relief on Property Assets

If you hold business property outside your company, you need to take extra care to make sure you qualify for entrepreneurs' relief when you sell up.

Entrepreneurs' relief in effect reduces your capital gains tax (CGT) rate to 10% on the first £1 million of gains on the sale of a trading company or an unincorporated business, subject to certain conditions. But extending relief to assets owned personally can be a bit more difficult.

For a sale of personally owned property to qualify for entrepreneurs' relief, it must be associated with a disposal of shares in the trading company or of an interest in a partnership in which the property is used. In addition, the property disposal must form part of the withdrawal of the individual from participation in the business. HM Revenue & Customs (HMRC) has said that withdrawal does not mean the individual has to stop working for the business, but there must be a reduction in the partnership share or a sale of shares.

In principal, there must be no significant interval between the disposal of shares or partnership share and the disposal of the property. HMRC does allow some exceptions. If the business has ceased, the sale of the property will qualify for entrepreneurs' relief if the disposal takes place up to a year after the cessation or up to three years if the property has not been used for any other purpose in the meantime.

Even where the business has not ceased, there can be up to three years between the withdrawal and the property sale, provided the property has only been used for business purposes during that period.

Entrepreneurs' relief is restricted if the company or partnership has paid rent for use of the property after 5 April 2008. This is because receiving rent makes the property, at least partly, an investment. The restriction is based on the period for which rent was charged since 6 April 2008 as a proportion of the period of ownership of the property, and the extent to which the rent is less than a full market rent.

Not charging rent will preserve entitlement to entrepreneurs' relief, but may cause you other problems, especially if you have to fund mortgage payments on the property. Please contact us if you would like to discuss your options.

Salary Versus Dividend

If you are both a director and a shareholder of your company, should you take extra income as a dividend or as a bonus? You can often save money by paying dividends, but the saving could be marginal and there are other factors to consider in deciding your remuneration strategy.

There are no national insurance contributions (NICs) on dividends, which is what produces the saving. Companies must pay employer's NICs of 12.8% on a bonus and deduct employee's NICs of 11% on earnings below the upper earnings limit of £40,040 and 1% on earnings above the limit. Against this saving is the fact that, unlike dividends, salary and employer's NICs are deductible against corporation tax.

If your company pays corporation tax at the small companies' rate of 21%, the saving from paying dividends is significant. Say, for example, you have profits of £10,000 out of which you want to pay a dividend or a bonus. A dividend would give you net income of £5,925, compared to £5,230 for a bonus. The saving is much less if your company's profits are more than £300,000, so that it pays corporation tax at the marginal rate of 29.75% or the full rate of 28%.

Paying dividends may allow profit to be diverted to a shareholding spouse. This could give additional tax saving if the spouse pays tax at the basic rate. The government intends to restrict this possibility from 6 April 2009, but there is still plenty of time to pay dividends before then.

Dividends do have some drawbacks however. They have to be paid at the same rate to all shareholders, making them less flexible, though you can overcome this by creating different classes of shares with different entitlements. Salaries can be paid even when the company is making a loss. Dividends can only be paid out of profits of the year or undistributed profits of previous years.

Dividend income cannot support pension payments. Having a low salary may restrict the amount of tax relief you receive when making payments into your pension scheme. And if you are near retirement and your pension will be based on earnings, you may need to enhance your remuneration at least in some years. Dividend income may also be treated less favourably by lenders if you are trying to obtain a mortgage.

We can help you decide which of these and other factors are relevant in your case and devise the best remuneration strategy for your circumstances. Please ask us for advice.

Tax Returns Controversy for Service Companies

A new question on the 2007/08 tax returns has caused controversy because of the ambiguous wording of HM Revenue & Customs' (HMRC) explanatory notes and because it appears designed to highlight taxpayers for enquiry.

People who provide services 'through a service company' are asked to state the total amount of income derived from doing so, even though this income – generally employment remuneration and dividends – is reported elsewhere in the tax return.

The term 'service company' is much wider than companies caught by the IR35 rules. IR35 service companies have to account for tax and national insurance contributions under PAYE on income from engagements that would be employment if the individual worked directly for the client under the same terms.

For the tax return question, services are provided through a service company where the shareholders provide intellectual or manual services to the company's clients and more than half the company's income (before deducting expenses) is derived from their work. If more than half the company's income consists of charges to cover materials or work done by employees, you need not answer the question.

The ambiguity in HMRC's explanatory notes resulted in HMRC issuing a revised explanation in September and a statement that there would be no adverse consequences for taxpayers who completed the question or left it blank in a tax return filed before then. The new explanation adds that you need not keep any additional records to determine whether more than half the company's income is derived from services performed by the shareholders but that 'best judgement' may be used.

One cannot get away from the fact that answering the question might result in HMRC opening an enquiry to determine whether the company falls within the IR35 rules, although HMRC's limited resources will mean that only a small percentage of tax returns will be questioned. If it is clear that the company's engagements are outside IR35, such an enquiry would have no consequences apart from being a nuisance.

Not answering the question may also result in an enquiry if HMRC thinks you should have done so. You may also leave yourself open to an enquiry after the normal time limit of one year after HMRC receives your tax return, because HMRC may argue that you have not provided enough information for it to be sure that your tax return is correct. If you are concerned that you may fall within IR35, you should get in touch with us now.

law LINES

Getting it Right on Redundancy

In the present economic circumstances, you may have to reduce your workforce. But making employees redundant is legally more complex than ever and so more important to get right.

What that procedure is depends on whether you are proposing 20 or more redundancies at one establishment within 90 days – a collective redundancy. If this is the case, you must consult your employees' representatives, such as a trade union, about how dismissals can be reduced, alternatives to redundancy, the selection criteria and how the consequences of redundancy can be mitigated.

Proper planning for redundancies is essential, whatever the numbers involved, especially the process of selecting who is to be made redundant. For example, using a length of service criterion could be risky because it could amount to age discrimination against younger employees. The employer must be able to show the process is consistent, fair and justified. A woman on maternity leave must be given priority to retain her job or otherwise offered an alternative job, if one is available.

The actual dismissal must follow the statutory procedure commonly known as the 3-step process. This specifies formal meetings between the employer and each employee, written reasons for the dismissal and an appeal procedure. The employer must also give a written statement to a redundant employee setting out how statutory redundancy pay has been calculated, and can be fined for not doing so. In a collective redundancy, the employer must also notify the Department for Business, Enterprise and Regulatory Reform.

An alternative to making employees redundant might be to offer them short-time working or a lay-off period, provided this is allowed in the employment contract. But employees put on short-time working or laid-off can treat themselves as redundant, giving them a right to redundancy pay, if some conditions are met.

Redundant employees with at least two years' service are currently entitled to statutory redundancy pay up to £9,900, based on age, length of service up to 20 years and weekly pay up to £330. We can help you to calculate this.

business MATTERS

Managing the Financial Crisis – Make a Plan

The Federation of Small Businesses (FSB) conducted a snap poll in September that highlights the impact of the credit crunch on small businesses. The results revealed that over 80% of respondents said their costs had increased in the last year and 46% had seen a decrease in trade.

Worrying developments include increases in the cost of finance, such as loans and overdrafts, and extended payment times on invoices. But there are practical ways in which firms can manage their response to the present crisis. For example:

Focus on cash flow

Issue invoices promptly and chase up debtors. Don't buy more stock than necessary and where possible negotiate longer credit terms with suppliers.

Review sales and marketing plans

You can't just stop telling people you are in business, but you can look at the return on investment of marketing activity and concentrate on the most profitable products and most efficient ways of reaching customers. Try an email campaign instead of direct mail and review how effectively you use your website.

Retain your customers

Apply the '80/20 rule' – work out who your most profitable customers are (the 20%) and focus on looking after them. Loyalty schemes, small discounts and regular communication should help you maintain key relationships.

Cut back on costs

Look for savings in every part of your business. This could include selling redundant equipment, changing office space or clamping down on everyday expenses. Review existing contracts and get new quotes from suppliers – it never hurts to ask.

Credit check customers

Protect yourself from bad debts by conducting credit checks and agreeing clear payment terms up front with all your customers, not just new ones. It might only take one major customer to go bust to jeopardise your business.

Avoid borrowing at high rates

Bear in mind loans can be more difficult to obtain and more expensive in a slump. If you had plans for expansion, make sure your finance-raising strategy will not leave you further in debt.

If you find yourself in difficulty and need help, ask for advice sooner rather than later. Getting independent help in time can save you from experiencing more serious problems in the future.

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 October 2008.