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A Difficult Customer - a Cautionary Tale

I have just settled an "Employer Compliance Enquiry" for one of my clients and I think it should serve as a warning to all employers, and indeed to all those who are the subject of a Revenue Enquiry of any sort.

You will have to forgive me if I do not go into the technical details of the points that were disputed - to do so might identify the business involved, and in any case, this article is not about the technicalities (fascinating though some of them were, including studying a tax case heard in the previous century involving payments to Scotland Yard detectives!).

An "Employer Compliance Enquiry" involves two main aspects. The "Employer Compliance Officer" (ECO) will check that the PAYE regulations have been properly applied to payments to employees - in the case of larger employers like the one I was dealing with, this is mostly done electronically, by interrogating the payroll software. The ECO will also look at expenses payments and benefits in kind provided to employees to ensure that these are properly reported and taxed.

My client has a very competent accounts department and they took the view that they could handle this apparently routine enquiry without my help. I was not so sure, but the customer is always right so I contented myself with warning them to check with me before they agreed any additional tax was due.

The PAYE side of things went fairly well. Apart from a few slip-ups (inevitable in the case of a large payroll), there was only one significant mistake which was largely due to a weakness in the proprietary software the client used for their payroll. So far, so good, and we put our hands up and paid the tax due.

It was when the Enquiry turned to expenses and benefits that things got ugly. The ECO homed in on two main issues: travelling expenses and accommodation provided for employees. Her letter to the client asserted that tax was due on most of the travelling expenses and nearly all of the accommodation, and required the client to provide her with details for the last six years so that she could calculate how much tax

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- Prompt
- Reliable
- Competitively Priced

We encourage clients to speak to us whenever they need advice. We do not charge for telephone calls and make a point of avoiding jargon whenever possible. Before staring any work we give you a fixed fee quote. There are no hidden extras, just peace of mind.

This newsletter is provided to you courtesy of:

Maidment Judd
Charter House Marlborough Park
Southdown Road Harpenden Herts
AL5 1NL

Email: rkendall@maidmentjudd.com
Web: www.maidmentjudd.com

Tel: 01582 469500
Fax: 01582 469550

was due. The biggest problem was the accommodation - the tax at stake was in the hundreds of thousands of pounds when you looked back over six years.

The ECO's letter simply asserted that the tax was due. Asked why, she quoted from HMRC's instruction manuals, not from the legislation itself. Now, although HMRC's manuals are generally quite good at summarising the law, they are not in fact the law and in some cases they generalise too much. My client's circumstances were very unusual and were not covered by the manual.

The client rang me up and asked me to look at the assertions the ECO was making about what was taxable. To cut a long story short, after a spirited exchange of letters and "referring the matter to my Head Office" from the ECO, she eventually agreed that none of the accommodation was taxable and that a large slice of the travelling expenses were also free of tax.

I do not tell this story to brag about how good I am at tax (though I reckon I'm pretty good!), but to draw attention to a serious problem with the way the tax legislation is enforced. ECOs are not experts in the finer points of tax legislation - witness the fact that most of my arguments had to be "referred to Head Office" - but this does not stop them from looking at a situation and demanding tax based on a generalised overview of how the legislation works. I remember that culture from when I was a Tax Inspector - at an early stage in my training, I was told "if in doubt, disallow the expense or say the payment is taxable and let them try to argue it's not".

The problem is that revenue officers these days present themselves to their "customer" (their own ridiculous word to describe the person they're seeking to tax!) as being fair and neutral - "we only want to make sure you pay the correct amount of tax". For some inexplicable reason, people still tend to think that government officials know what they are doing and believe they would not demand money unless it was due. They are wrong. A revenue officer, confronted with something that may or may not be taxable, will work on the basis of claiming tax and letting the "customer" make the running if they disagree.

Of course, in many cases they are right, but never assume they are without taking expert advice. Most of all, remember that they are not on your side - I am not advocating that you behave in a hostile manner, just that you take proper advice before you accept what they tell you. When I am acting for a client, I really am on their side, because they really are my "customer". Revenue officials now also call you a "customer" - if he could talk, my cat might as well call the local mice his "customers"!

Tax Tips

If you are a widow or widower who may benefit from the new transferable nil rate band for inheritance tax, it would be wise to get the paperwork from your deceased spouse's estate together and store it with your Will so that your executors will be able to claim the extra nil rate band with the minimum of fuss.

Good News for Those with Small Income Tax Bills. The threshold for making payments on account of your self-assessment tax liability has been raised from £500 to £1,000 - but don't celebrate too soon - it only applies from 2009/10.

DO charge VAT on supplies to your staff (except for food, drink and accommodation provided free to catering & hotel employees)

DON'T claim the VAT on the purchase of a motor car - it will not be recoverable except in some very special circumstances

If you have just started trading, don't forget you have to notify HMRC of the fact within three months - from April 2009 the penalties for not doing so are to be increased, but even before then, it is still a bad idea to put your head in the sand!

Q&A

Q1 My husband took equity out of our main residence twice and used all the money to buy some buy to let properties.

So, can the extra interest that he is now paying on his main residence be set off against his tax/income?

A1 Provided that the cash from the equity release was used only to acquire the buy to let properties, then the interest on the loan can be set against the rental income. I am assuming that the main residence and the buy to let properties are either both owned by your husband in his sole name, or are both jointly owned - if this is not the case, you need further advice.

Q2 Are the legal fees that are incurred with the purchase of a buy to let property allowed as taxable expense?

A2 Not as an expense against the rental income - they are treated as part of the cost of the property for the purpose of capital gains tax when it is sold.

Q3 Will I pay tax on the sale of my main residence if I own a separate piece of land? The land in question has been gifted to me from my parents; it is part of the grounds of their PPR. I currently have a planning application going through for a dwelling on the plot for my own personal use. I am looking to sell my main residence soon and would like to know if there are tax implications because of the gifted land. Currently the application to build on the land has been declined and is going through an appeal.

A3 You are entitled to the exemption for main residence on the old property. Assuming you have lived in it since you bought it, there will be no CGT to pay on the sale. Because it has been your main residence, the last three years of ownership are deemed to be exempt from CGT as well, even if you have moved into the new build during that period. As far as the new land is concerned, provided the house is completed and you move in within one year of the gift (or up to two years if you can show there were exceptional reasons for the delay), then there will be no restriction of the exemption for a main residence when you eventually come to sell it.

Q4 My Partner and I jointly own two neighboring flats; we have resided in one for 9 years, purchased the neighboring flat 3 years ago and have rented it out ever since. We are considering converting both flats into one large property to live in rather than pay costs to move.

Will we be charged stamp duty on registering the two flats as one property (obviously we paid stamp duty originally on both)?

Will we be liable to pay CGT upon conversion for the rented flat?

A4 No Stamp Duty Land Tax and no CGT if you occupy the enlarged flat as your main residence. When you eventually sell, there may be some CGT payable in respect of the three years the second flat was let out, but there is an exemption of up to £40K for each of you in respect of this so it is unlikely that there would be very much tax payable.

Changes to Capital Allowances on Plant and Machinery

The Chancellor's Pre-Budget Report in October of last year announced major changes to the way businesses can claim relief for capital expenditure.

The headline news was the scrapping of Industrial Building Allowances, which allowed you to write off the cost of constructing industrial buildings (and hotels and agricultural buildings) over a 25 year period. Particularly vicious was the way this applied to expenditure already incurred, so that entrepreneurs who have already spent very large sums in the expectation of getting these tax allowances will have to deal with a severe blow to their cash flow forecasts as a result of the loss of this important tax relief.

This article, however, concentrates on the changes to the allowances for expenditure on plant and machinery. Broadly speaking, they are good news for smaller businesses, and bad news for larger ones - the cut-off point is at around £130,000 of annual capital spending on plant, with those over that level finding that they will have to wait longer to get tax relief on their expenditure, and those below it getting their relief earlier.

The Old Rules

Before the changes were announced, expenditure on plant and machinery was the subject of two types of allowance - First Year Allowances and Writing Down Allowances ("FYA" and "WDA").

A "small business" could claim FYA at 50% on its expenditure in the year, and a "medium sized business" could claim 40%. The balance of the expenditure was carried forward and attracted an annual WDA of 25% in the following years. If a "small business" spent £50,000 on a new piece of machinery, therefore, in the first year it could claim 50% (£25,000) FYA, and in the following year, WDA at 25% on the balance (£25,000 times 25% = £6,250).

Long Life Assets

Certain types of plant are categorised as "long life assets" if they have an expected useful life of 25 years or more, and the WDA on these was lower at 6%. "Long Life Assets" are quite rare, but the oil industry has many of them, and given the threats to move their HQs out of the UK made to the Chancellor last year by the big oil companies, it was not very surprising that the WDA for such assets was increased to 10% from April 2008.

The New Rules

For expenditure incurred after 5 April 2008 (31 March 2008 for companies) the FYA is scrapped, and the WDA is reduced to 20%.

The Annual Investment Allowance ("AIA")
Instead of FYA, a business will have an AIA of £50,000, on which it can claim 100% relief. Any expenditure over £50,000 will be the subject of a WDA of 20%, so if the business spends £100,000 on plant in an accounting period, it will get an AIA of £50,000, and £10,000 WDA on the balance. Compared with a FYA of £50,000 under the old rules (with no WDA until the next year), this is an improvement.

In the case of a group of companies, or "related businesses" (we look forward to hearing exactly what this means!), there is only one AIA of £50,000, and the taxpayer can allocate it as they wish between the various companies in the group.qualify as an EIS company.

"Integral" Plant

For a number of years, there have been heated disputes between HMRC and taxpayers as to exactly what is plant (qualifying for FYA and WDA) and what is a part of the building itself (qualifying for either nothing or industrial buildings allowance at 4% in some cases).

From April 2008, we have a new category of "integral" plant. This is plant that forms part of a building. Such plant will attract a WDA of 10%.

In some cases, this is good news - for example, the electrical wiring of a building was not plant or machinery under the old rules unless you could make a case that it was a specialised installation to meet the needs of specific plant installed in the building. From April 2008, it will be "integral" plant, and will attract WDA at 10%.

In other cases, it is bad news - space or water heating systems currently qualify for FYA (and WDA at 25% on the balance), but from April they too will be "integral" and only attract 10%.

In a few cases, the new rules are quite mysterious - "active facades" will be "integral" and get the 10% WDA. Frankly, I have no idea what an "active facade" is but my Senior Manager tells me she thinks it is an external wall on which you can display messages or change the colour to suit the atmosphere.

Interaction of AIA and Integral Plant
We have seen that there is an AIA of £50,000 on which 100% relief can be claimed. This can be claimed on any plant, including "integral" plant, so (at the risk of stating the obvious), the trick is to make sure you claim the AIA against "integral" plant (10% WDA) before normal plant (20% WDA).

Small Pools

I am not referring to those plastic things which invariably leak and turn your garden into a swamp, but to one of the very few really sensible measures in the Budget.
The expenditure on plant and machinery above the amount qualifying for FYA (or, under the new regime, for AIA), is carried forward as the "pool" of expenditure that qualifies for WDA in the following year.

Until now, you have had to keep calculating the WDA on the "pool" every year, even when it reaches a ridiculously low figure like £100 (WDA of £25 due and £75 carried forward to next year).

From April, once the "pool" reaches £1,000 or less, you can simply write it all off and claim allowances on it.

Other Capital Allowances

There are other significant changes to capital allowances, either now or in the pipeline for next year, many of which have an emphasis on "green" technology. These will be the subject of an article in a later edition of the Tax Insider.

EISy Does It - A Tax Shelter for the intrepid investor

The "Enterprise Investment Scheme" (EIS) is the latest incarnation of a series of schemes offering tax breaks to those prepared to invest in trading companies.

Its grandparent was the "Business Expansion Scheme" launched in the early 1980s. Like most schemes involving tax relief, the EIS has been tinkered with and amended in successive Finance Acts, and the detailed rules are extremely complicated, but the basic concept is simple.

The EIS offers tax breaks to individuals who subscribe for new shares in UK trading companies. In particular:

- An income tax repayment of 20% of the amount invested, up to a limit of £400,000 investment per tax year (so a maximum repayment of £80,000)
- Exemption from CGT when the shares are sold, provided they qualified for the income tax relief referred to above
- The ability to defer paying CGT on any other capital gains in the year, to the extent that the gain is reinvested in EIS shares - unlike the other two reliefs, there is no upper limit to the gain that can be deferred. When the EIS shares are sold, the old gain becomes chargeable again

EIS Companies

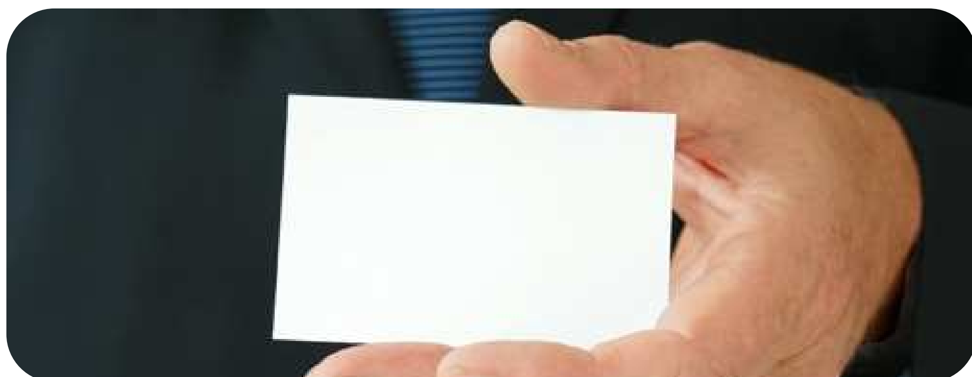
There are a number of rules that an EIS company must obey. Essentially, it must be a company trading in the UK, not a subsidiary of another company, not listed on the Stock Exchange and the trade it carries on must be a "qualifying business activity".

There are also limits on the size of the company, so companies with substantial assets will not qualify.

"Qualifying Business Activity"

This is defined by exclusion, and the basic idea is to weed out trades that are too "safe" because, for example, they are backed by an investment in land. Hotels do not qualify (though, curiously, pubs and restaurants do) and nor does property development or farming.

There are other restrictions too, which I tend to think of as the "yuppie traps". They date from the old BES scheme of the 1980s and prevent tax relief for investment in such "safe" things as fine wines and fine art.



There is no space here to go into the finer details, but HMRC do operate an informal clearance service in cases of doubt. The company can ask HMRC to confirm that its trade does or does not qualify for EIS status.

Quarantine Period

Most of the conditions for getting EIS relief apply for a period that begins one year before the investment is made, and continues until three years after the shares have been issued. This can lead to problems. I have seen too many cases where the company was so busy trading and expanding (or struggling and shrinking!) that it forgot the various rules it had to obey to avoid its shareholders getting their tax relief clawed back.

The "connection" Rule

In order to qualify for income tax relief (and thus the CGT exemption) the investor must not be "connected" with the company during the quarantine period.

The main way to become "connected" is if you (or you and your close relatives between you) own more than 30% of the company.

You will also be "connected" if you are made a director of the company, although there is a rather complicated exemption from this rule for so-called "business angels" who invest in companies they have not previously had anything to do with.

Note that this "connected" rule does not apply to the CGT deferral relief described above. You can be as "connected" as you like and still defer a capital gain, but you will not get the income tax repayment or the CGT exemption.

"Receiving value"

An EIS investor is not allowed to "receive value" from the company during the quarantine period. There are some exceptions to this rule, but in general it pays to be very careful not to take anything out of the company without checking with a tax adviser first.

Ask an Expert

If you are contemplating investing in a company and you think you might qualify for one or more of the EIS reliefs described above, talk to a tax adviser before you do anything else.

The fine detail of the EIS legislation is a minefield and it is all too easy to deny yourself the relief accidentally.

To take only one example, if you set up a new "off the shelf" company, you must generally get your EIS investors in and issue them with their shares before the company does anything else, and make sure that when you do issue the shares they are all issued together so that no-one gets his early and becomes "connected", because for a brief period he has more than 30% of the shares that have been issued so far.

EIS in Practice

EIS companies range from those set up by a group of friends with a new business idea, to more formal enterprises set up by professional company promoters.

If you are considering setting up a company, or if you have an existing company and are looking to raise new finance by issuing more shares, it is always worthwhile checking to see if the company could qualify as an EIS company.

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