

Issue 27
March 2008

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Entrepreneur's Relief - The Devil in the Detail

By James Bailey

I covered the new Entrepreneur's Relief ("ER") in last month's Tax Insider, but I make no apology for returning to it this month because now that the draft legislation has been published, we have a clearer idea of what will and will not qualify for ER, and the news is not good!

Background

When the scrapping of Taper Relief and the indexation allowance was announced in October, both the TUC and the CBI were up in arms about its unfairness. As a result, the Chancellor announced that ER would produce an "effective rate" of 10% on gains on business assets after April 2008.

The new ER is restricted to the first £1million of gains arising to an individual, or to trustees, after 5 April 2008, but in other ways as well it is much less generous than taper relief.

Last month's article pointed out that there were several classes of assets that qualify for

business asset taper relief but will not qualify for ER, but until we saw the draft legislation we did not realise two very important differences that were either ignored or glossed over in the original press release.

Sale of Business Assets

Under Taper Relief, a gain on a sale of an asset used for a trade carried on by a sole trader, a partnership or an unlisted limited company could be reduced by 75%, subject to certain conditions, giving an effective rate of CGT of 10% for a higher rate taxpayer.

Under ER, the conditions are much tougher and many assets that qualified for taper relief will not qualify for ER.

Sale of a Business or "part of a business"

ER will only be available when you sell "a business or part of a business", or where your



business ceases trading, you will have three years to dispose of the assets and claim ER on the capital gains you make on the sale of them.

With taper relief, the business did not have to cease - a sale of an asset used for the business qualified, even if you were carrying on trading.

What is "part of a business"?

HMRC have let it be known that they propose to interpret this phrase in the same way as they used to interpret it in the days of "Retirement Relief" (which was replaced by taper relief in the late 1990s).

"Part of a business" means an identifiable part of the enterprise. Most of the old Retirement Relief tax cases involved farmers, and they provide a good example of the difference between ER and taper relief.

If a farmer sells one of his fields to a property developer, that would qualify for business taper relief but not for ER because it is not a "part of a business", just an asset used for the business.

An example of a sale of "part of a business" by a farmer would be a sale of a significant amount of grazing land, the milk parlour, the milk quota and the dairy herd - because that is the sale of the dairying "part" of the business.

Furnished Holiday Accommodation ("FHA") qualifies for ER, provided the rules about the number and duration of the lettings are

complied with, but it will be interesting to see whether the sale of one holiday let by a landlord who retains one or more other holiday lets will be treated as a sale of "part of a business". HMRC's capital gains manual does not go into the question, but it does give an example of the sale of a shop by a trader who runs two shops. Whether this will be a sale of "part of a business", says the manual, "depends on the facts" - this is HMRC-speak for "will be the subject of an expensive and nit-picking argument". The manual gives two examples where they would accept that the one shop sold was "part of a business":

- Where the trades are entirely distinct - such as a butcher's shop and a clothes shop
- Where the type of customer is different - such as one wholesale warehouse and one retail shop

The implication is clearly that if you own two similar shops - say two shoe shops - HMRC will argue that the sale of one of them is not the sale of "part of a business", but merely the sale of a business asset, and does not qualify for ER.

In the case of FHA, then, will the sale of one holiday cottage be a disposal of "part of a business" if you still own one or more others? Only time and the law courts will tell.

Rent Paid

Currently, if you receive rent for the use of business premises, this is entirely irrelevant to qualifying for business taper relief, but

for ER the relief will be restricted in a "just and reasonable" manner, depending on whether the rent was below a market rate or not. If it was at a market rate, then no relief will be due.

A very common trading structure is to run a business through a limited company, but to own the premises outside it, and to charge the company rent for occupying them. This has a number of advantages, both from a tax point of view, and also on more general commercial grounds - if the company goes down the pan, you are still left with the most valuable asset in the shape of the premises it traded from.

Such a structure will mean that ER is either restricted or denied on a sale of the premises when the trade ceases or the company is sold, depending on the level of rent paid.

This does not mean that such structures should necessarily be dismantled by transferring the premises into the company, but it does mean that the position needs reviewing in the light of the strategic plan for the whole of the business.

ER is not a replacement form of business asset taper - it is a much more restricted and complicated relief, and one that is going to cause a lot of disputes between HMRC and taxpayers.

TAX INSIDER TIPS



- Did anyone else spot Budget Notice 61 ("Greater London Authority Severance Pay")? This provides an exemption from tax for payments made to GLA officials under their severance pay scheme, and it specifically mentions the Mayor of London as one of those included in the exemption. Looks like they have little confidence in your chances in the coming election, Ken!

- Stamp Duty is chargeable on transfers of shares, at a rate of ½ percent on the amount paid for the shares, rounded up to the nearest £5, so on a sale of shares for less than £1,000 the Stamp costs £5. With effect from Budget Day, transfers where the duty would be only £5 will be exempt.

- A new power has been announced for HMRC to visit a trader's premises and inspect his records and assets used in the trade - this can already be done for VAT purposes, but now it is being extended to direct tax (income tax, corporation tax, and CGT), with effect from April 2009.

- Were you in one of the queues outside a Northern Rock branch during the great panic between 13 and 19 September last year? Did you pull the cash out of your ISA? If you put it back before 5 April 2008, (in Northern Rock or any other ISA provider), it will still qualify for the ISA tax free status.

- If you make an error in your VAT return of less than £2,000, you can simply correct it in the next return without having to draw attention to it. This limit will be increased for accounting periods beginning after July 2008, to the greater of £10,000 or 1% of turnover, subject to an overriding limit of £50,000.

- 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!

James Bailey

Changes to Capital Allowances on Plant and Machinery

By James Bailey

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.

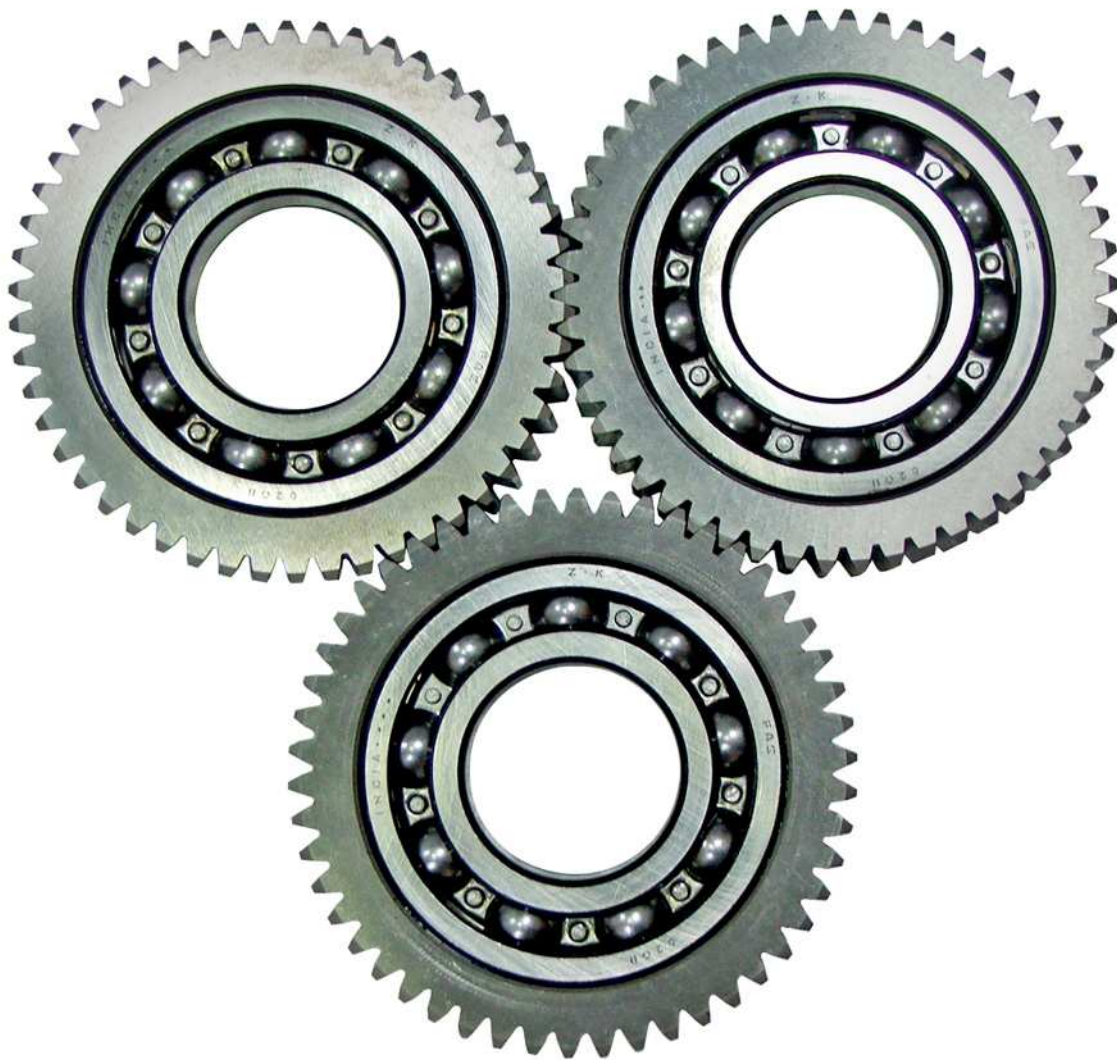
The New Rules

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.





"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.

Budget 2008 - the Overseas Aspect

By James Bailey



Several of the Budget Notices dealt with the treatment of those who are either not resident in the UK or not domiciled here.

We looked at the position of those who are not UK domiciled in the November 2007 Tax Insider, and the Budget broadly confirmed the position as it was announced in October 2007, but there was a small but potentially significant change to the rules for deciding whether a person is UK resident which was announced in the Budget.

Whether you are "resident" in the UK for tax purposes can have a significant effect on your tax liability here.

Whether or not you are "resident" in the UK is decided by a confusing mixture of statute law and case law - there is a marvellously silly tax case (*Cooper v Cadwallader*) which established that an American attorney who rented a grouse moor (complete with shooting lodge) made himself UK resident because the shooting lodge counted as accommodation in the UK that was "available" to him. This case was overturned by legislation some years ago, but it gives you the flavour of the obscure rules that come into play when one has to decide where a person is resident for tax purposes.

Tax for Non-Residents

If you are not resident in the UK, your liability to UK tax is limited to income arising in the UK, and perhaps even more significantly, you are not liable to UK CGT, even if the asset concerned is in the UK - there are some

esoteric exceptions to this rule, but in general this is the case.

It can therefore be very significant for tax purposes whether you are UK resident or not. Dave Clark, of the 1960s band The Dave Clark Five (in my view, their soulful ballad "Bits and Pieces" is the finest song about a failed love affair ever recorded, and it has the added merit that I can actually play the drum part) saved himself a fortune in UK tax by making himself non-resident for a crucial tax year during which he was due to receive huge royalty payments from offshore.

Days Spent in the UK

One of the simplest tests for residence or non-residence is the "182 day" test. If an individual spends more than 182 days in the UK during a tax year (that is, a year ending on 5 April), then he is deemed to be resident in the UK for the whole of the tax year concerned.

HMRC's manual on the subject (IR20) used to say that "days of arrival and departure" were not "generally" included as days spent in the UK, though in one or two cases (one, for example, involving an airline pilot), they chose to argue against this proposition and were successful.

On Budget day, Alistair Darling announced that the rule for deciding whether a day was spent in the UK for tax purposes would be put on a statutory footing, which was good news given the uncertainty which had surrounded the issue after the unfortunate airline pilot lost his case.

Initially, in the Pre-Budget Report in October 2007, the proposal was to include days of arrival and departure as days spent in the UK, but in the Budget Note dealing with the issue, this had been softened slightly.

For the tax year 2008/09 and following years, you will be treated as being in the UK for tax purposes on any day on which you were present here at midnight at the end of the day. I suppose that, effectively, this means that days of arrival will now be counted, whereas days of departure will not, as long as you have left by midnight.

Back in the 1980s, when I was still a tax inspector, Heathrow airport was fogged in on a night near to the end of the tax year. Bearing in mind that in those days, the day of departure did not count as a day spent in the UK (as apparently it still will not), those of the international non-resident set had a significant vested interest in not being in the UK after midnight, so that the day in question would count as their day of departure and thus not be counted for tax purposes.

I was not present, but the story goes that as midnight approached and the airport remained unable to allow any planes to take off because of the fog, some ugly scenes developed between the airport staff and some seriously rich people who had been carefully counting their days in the UK during the tax year and really needed to be off UK soil before midnight!

How to Pay Off Your Residential Mortgage and Claim Interest Relief?

By Amer Siddiq and Arthur Weller

Now, doesn't that sound like a great idea - getting tax relief on the mortgage interest that you pay on your main residence?

Well, you will be pleased to hear that it is possible by following a simple (and relatively unknown) tax relief and some creative financial planning.

The Basics

As most property investors are aware, it is not possible to claim interest relief on your main residence. This is because your main residence does not form part of the property business.

Therefore, because no rental income is received from your main residence (exception being the rent-a-room-relief), you cannot claim interest relief against your income.

However, you will also be aware that you can claim interest relief on properties that form part of your property business i.e. your buy-to-let portfolio. In such instances you can offset your mortgage interest on your let properties against any rental income received.

Introducing BIM45700

BIM 45700 was first introduced by us back in October 2004. In an article, we identified how this little known strategy gave landlords the opportunity to release equity from their investment properties and offset the interest regardless of what the equity release was used for.

The only restriction is that the equity release cannot be greater than the market value of the property when it is brought into the letting business. If the property had been originally bought for letting, this amount would be the purchase cost of the property.

So How Do We Get Tax Relief on Our Main Residence?

Well there are two ways to achieve this:

Remortgaging existing buy-to-let property/portfolio

Those of you who have or are growing a buy-to-let portfolio are likely to have equity in the property. The example below shows how/when this equity can be released to give you a tax benefit.

Example

John buys a property for £200,000. He provides a £40,000 deposit and borrows £160,000. Five years later the property has increased to £250,000. This means that he has £90,000 equity in the property.



He decides to remortgage the property to a value of £200,000 thus releasing £40,000 of equity from the property. He uses the £40,000 equity release to reduce the mortgage on his main residence by £40,000 and still claims interest relief on this equity release.

Now you will be asking how is this possible?

Well, don't forget the property was bought into the lettings business when it was purchased for £200,000. The additional amount of equity released has not taken the borrowing over £200,000, so the entire interest amount charged can still be offset against the rental income.

So if, say, for example he is paying £200 a month interest on the £40,000 then he will be able to now offset this interest against his rental income.

Result:

- Reduced debt on the main residence
- Borrowing moved to buy-to let property upon which interest relief can be claimed against the rental income

Now this is just an example of a single property. Imagine if you have 2, 3, 4 properties or more and have the ability to withdraw equity as in the example shown above?

By using this same strategy on a number of properties, you could shift the entire debt from your main residence on to your buy-to-let property portfolio and claim interest relief on the entire amount!

Moving Equity from Previous Residence

Another useful tax trick is to remortgage a previous main residence. Again this strategy is best illustrated by an example.

Example

Lisa and John buy a property for £100,000 (£20,000 deposit and £80,000 mortgage). They live in the property for five years and then decide to buy another property. Instead of selling their existing residence they decide to get onto the buy-to-let ladder and let the property out.

The cost of the new property is £200,000, and at the time of letting, their previous residence is worth £150,000.

They increase their debt on the previous residence from £80,000 to £150,000 i.e. they release £70,000 of equity. They then use this equity release to reduce their mortgage on their main residence by £70,000.

Once again, because the additional amount of equity released has not taken the borrowing over £150,000 (the price when it was brought into the lettings business), the entire interest amount charged can still be offset against the rental income. If the interest charged on this amount was £250 per month then this is a significant saving every month.

Once again, with this little trick we have:

- Reduced debt on the main residence
- Moved borrowing to buy-to let property upon which interest relief can be claimed against the rental income

Conclusion

As you can see, sometimes with a little bit of creativity you can bring significant tax savings! It is possible to get even more creative with this tax break but we'll leave these strategies for another time.

HMRC Issues Tips on How to Complete the Vat Registration Application Form More Effectively By Andrew Needham



HM Revenue & Customs

At the beginning of December 2007, HMRC posted the following guidance on its website in relation to the completion of VAT1 registration forms. Presumably, the tips are intended to work in tandem with HMRC's ongoing drive to reduce the length of the much-publicised delays in the registration process.

Box 1 - status

Partnership: You will need to enclose VAT2 form with details (including the National Insurance number) and signature of each partner.

Limited Company: You must provide the company number and incorporation date. The date you are applying to be registered from must be after the incorporation date.

Box 5 - Business address/telephone number

This should be the address in the UK where the day to day running of the business is carried out. Other address - such as 'care/of', PO Box, an accountant's address, or a non UK address or telephone will be queried and this may delay your application.

Box 6 - Business activity

Please provide a full description of the business activity - for example 'wholesaler of fruit and vegetables' or 'management consultancy services'. Less clear descriptions such as 'wholesaler' or 'consultancy' will be queried.

Box 7 - Associated companies

This must be completed if any of the partners or directors are currently, or have been in the last two years, involved in any other business. Full name(s) and VAT number(s) of those business(es) are required.

Box 8 - Bank account

If your bank account is still being set up, you should provide any evidence you have to support this - for example a copy of the application form or other correspondence with your bank. Please do not enter duplicate bank information of associated business(es).

Boxes 9 - 12 - Transfer of a Going Concern

If you are taking over (or about to take over) a business as a going concern you must complete boxes 9-12. To use the previous owner's VAT Registration Number also complete and send Form VAT68 (taking over a previous owner's VAT Registration number may not be sensible for your business so ensure you understand the implications and/or take advice on this before deciding).

Box 13 - Registering on a voluntary basis (i.e. relevant turnover is below registration limit)

Please tick the appropriate box and specify the date you want to be registered from in box 13 only - do not complete boxes 14 or 15.

Boxes 14 and 15 - Compulsory registration (i.e. relevant turnover above registration limit)
You will need to complete either question 14 or 15. Please identify which question applies (check with the guidance notes) and answer that question only.

Box 19 - Estimated turnover of taxable supplies

This box must be completed - please use your best judgment to make an estimate. Leaving the box blank will cause queries and delays.

Boxes 20 - 21 Exempt and EU supplies

You must tick either the 'yes' or the 'no' boxes for these questions - and provide the estimated amounts you answer 'yes' to the EU questions. The guidance notes (with the VAT 1 form) will help you identify exempt supplies.

Boxes 22 and 23 - Details and declaration

These boxes must be completed by the appropriate person. (see the introduction to this section). The necessary details (name, address etc) of the person must be given. The signatory must say in what capacity they are signing - for example as sole proprietor or as director or as a partner. Leaving boxes blank will cause queries and delays.

The Tax Insider Gurus Answer Your Questions

Q.1

I have lived overseas (Canada) for 27 yrs. In 1999 my mother gifted her home jointly to my brother and me. She has lived there rent free since then.

What tax implications are there for my brother and me when we sell the property? He still lives in the UK and property is approx £100,000 pounds.

A.1

Assuming the sale takes place after 5 April 2008, your brother will be liable to CGT at 18% on his half of the gain. Assuming you remain non UK resident, you will not be liable to UK CGT but you should check to see if you have any liability in Canada. Your Mother "reserved a benefit" when she gifted the property to you, so for inheritance tax purposes she is treated as still owning it until she moves out. Provided she survives the sale by seven years, the value of the property will not be included in her estate.

Q.2

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.

A.2

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.

Q.3

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?

A.3

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.

Q.4

I'd like to buy a property in my son's name who is 16 on May 21st 2008. Are there any problems with doing this?

A.4

As he is under 18, he cannot legally own property directly. You should take good legal and tax advice before you do anything else.

Send your questions to: questions@taxinsider.co.uk for consideration in future editions.

Tax advice and help to solve your challenges at an affordable price!

The contributors to this e-zine are current practising specialists. They have made available an advice and helpline service to help resolve any UK and international tax matters.

Please visit www.taxinsider.co.uk for more information about this affordable service.

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