

# HEYWARDS NEWSLETTER

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### SMALL BUSINESS TAX AND FINANCE

#### The Line Between Managed & Personal

In his Pre-Budget Statement last month, the Chancellor of the Exchequer announced that, from 6 April 2007, everyone working through a 'managed service company' will be taxed as an employee. A 'managed service company' is similar to a one-man, or one- woman, personal service company, in that it exists only as a trading vehicle through which an individual supplies his or her services to clients, but there is an important difference. Whereas the proprietor of a one-man personal service company runs it himself, and is almost always a director of the company, a managed service company (MSC) is run by a business set up to run MSCs. That business will, for example, provide the company's directors and operate its bank account.

Various types of MSCs exist, some being known as 'composite' or 'umbrella' schemes because they allow a number of people to work, independently, through the same company. Like personal service companies, they largely pay out their profits in dividends rather than wages, to save National Insurance contributions.

The Chancellor's objection to these arrangements is that a large proportion of the people working through MSCs are really agency staff (including nurses, teachers and even cleaners), who he believes should be taxed as employees. Indeed, some large agencies operate in-house MSC schemes for the staff they supply.

The important point to stress is that the new rules for 'managed service companies' will not affect anyone working through their own personal service company - one where they are the directors, they sign the cheques, etc. Personal service companies will, of course, remain subject to the IR 35 legislation and to the final decision in the Arctic Systems case (which the House of Lords is scheduled to hear in June).

Some people currently working through managed service companies may be able to retain their 'non-employee' status if they can set up their own personal service company without being caught by IR 35 - this is a question on which individual advice will be required, because the range of factual situations which can exist is almost limitless, and the answer always depends on the facts. Interestingly, although managed service company providers advertise that they provide a cost-effective service, on the Government's figures the service only looks cheap because it is charged for on a weekly or monthly basis. Again on the Government's figures, running your own personal service company with the assistance of an accountant will cost less than half of the amount typically charged by MSC providers.

#### Construction Industry Scheme

The Chancellor also announced that, from April, the rate of tax deducted under the Construction Industry Scheme will rise to 20%, because the current deduction of 18% is too low to meet the full tax and National Insurance liabilities of many subcontractors. The higher deduction rate for payments to subcontractors who have not registered with HMRC (those who are not 'verified' under the New CIS arrangements) will be 30% - it had been widely thought that the figure would be as high as 40%.

We should also take this opportunity to warn everybody working in the construction industry that the New CIS substantially increases the danger of identity theft. To 'verify' a subcontractor, a contractor has only to give HMRC the subcontractor's name, Unique Taxpayer Reference (UTR) number and (preferably) his National Insurance number (NINO). A dishonest individual could easily discover a workmate's UTR and NINO (for example, by going through the pockets of a jacket left in the site hut) and then impersonate him when applying for work elsewhere. Under New CIS there will be no plastic identity card, and no photograph (with or without a hat!), so the contractor will have no idea what the subcontractor is supposed to look like. Because of all the confusion and aggravation this could cause, we would strongly advise all subcontractors to keep as close a watch on their tax papers as they would on their credit cards, and all contractors to insist on payment by cheque.

#### 5 April 7 Deadlines

The end of the tax year is fast approaching - and this year 5 April will be the Thursday before the Easter holiday. For those keen to organise their personal finances in a tax-efficient way, the end of the tax year can be an important deadline in the following circumstances:

**Paying pension contributions** - Under the new tax régime for pension schemes, there is no longer a facility to 'carry back' a contribution, so that it is treated for tax purposes as if it was paid in the year before it was actually paid. Accordingly, if a pension contribution is to qualify for tax relief in 2006/07, it must be paid before Easter.

Basic rate tax relief is given by reducing the net premium paid to the insurance company, etc, operating the pension scheme, so if the contributor pays tax at the basic rate, and expects to continue working in 2007/08, it does not really matter - from a tax point of view - whether he or she pays a contribution before or after Easter. However, if the contributor retires early in 2007/08, the maximum contribution payable will be the greater of £3,600 (before tax relief) and an amount equal to his or her taxable profits in 2007/08. Accordingly, anyone about to retire, and who wishes to 'top up' his or her pension fund, should consider doing so before Easter.

The other circumstance where paying a pension contribution before Easter should be considered is where the contributor pays tax at the higher rate. Payment before Easter will allow the higher rate relief to be claimed a year earlier. More importantly, if the contributor is a higher rate taxpayer for 2006/07, but may not be for 2007/08 (for example, because he or she is retiring, or because business profits fluctuate, or because a sale of assets gave rise to a taxable capital gain in 2006/07), then it will be necessary to pay the pension contribution before Easter to secure the higher rate relief. Of course, this may also work in reverse: if the individual is not a higher rate taxpayer in 2006/07, but may be in 2007/08, then he or she should defer paying a contribution until after Easter.

**ISAs** - (Individual Savings Accounts) The annual contribution limit (£7,000 for adults and £3,000 for 16- and 17-year-olds) works on a 'use it or lose it' basis: if the contribution is not made by the end of the tax year, the balance may not be carried over to the following year.

It was hoped that the Chancellor would announce, in last month's Pre-Budget Statement, an increase in the annual contribution limit, but he did not do so. He did however promise that Individual Savings Accounts will be made 'a permanent feature of the savings landscape' - previously the availability of ISAs had not been guaranteed past April 2010.

**Capital gains tax** - There are many techniques which can be used to manage and reduce capital gains tax liabilities. At its simplest, a portfolio investor can review his or her shareholdings before the end of the year, to see whether a sale would crystallise a gain within the annual exemption (£8,800 for 2006/07), on the basis that taking a tax-free gain now may save paying tax on the same gain in a later year.

Straightforward bed-and-breakfasting (selling a shareholding and repurchasing it the next day) is no longer effective for tax purposes, but there are alternatives, such as sale by a husband and repurchase by his wife (or vice versa), sale of an individual's own shareholding and repurchase by his ISA, or (in some cases) sale of a personal holding to the individual's own Self-Invested Personal Pension Plan.

Where an individual's affairs are more complex, the tax year in which disposals are carried out may have a dramatic effect on the total tax payable. For example (and this is only one example), if an individual has capital losses brought forward, and both business and non-business assets to dispose of, it is important to ensure that the losses can be set against the gain on the non-business assets, as they are more heavily taxed. The tax relief for losses set against non-business gains can be worth four times as much as losses set against business gains.

There is one chance, and one chance only, to get it right. If transactions are carried out in the wrong sequence, the interaction of the complex capital gains tax rules can produce results which seem capricious and manifestly unfair, but it is almost never possible to repair the damage after the event. Because the rules are so complex, and the variety of situations which may arise in practice almost infinite, it is impossible to give any meaningful general advice. Clients planning substantial disposals, or otherwise with a complex capital gains tax position, are accordingly strongly recommended to arrange a consultation with ourselves.

**Inheritance tax** - Recent changes in legislation have made inheritance tax planning far more difficult - and the Government have made it crystal clear that they will take effective action to neutralise any new schemes that are devised by over-enthusiastic tax planners. That makes it even more important to take maximum advantage of the reliefs and exemptions granted by the inheritance tax legislation itself.

The simplest way of passing wealth to the next generation is to make lifetime gifts within the inheritance tax annual exemption. This exempts gifts of up to £3,000 each tax year (the limit is per donor, not per recipient), and an unused allowance can be carried forward for one year. Thus if no gifts were made in 2005/06, gifts up to £6,000 may be made in 2006/07. The exemption is not dependent on the donor surviving the gift for any particular length of time.

Given this 'double allowance' for the first year, a married couple could, over nine years, pass a total of £60,000 to their children or grandchildren, potentially saving £24,000 in inheritance tax. The limitation is, of course, that they do need to have money or other assets they can afford to give away.

**Private use of employer's van** - Where an employer allows an employee to use a van for private journeys, a benefit-in-kind charge may arise. Hitherto, there has been a 'scale charge' valuing the benefit at £500 a year, reduced to £350 if the van was over four years old. However, starting in 2007/08 the 'scale charge' will be increased to £3,000, or £3,500 if the employer also pays for fuel used for private journeys (as will usually be the case). This potentially ten-fold increase in the scale charge means that van drivers should consider whether the private use they make of their van is worth paying the tax charge.

However, no charge arises if the van is used only for business journeys (for example, delivering goods, making service calls) and for home-to-work mileage. Also, there is a disregard for 'insignificant private use': the examples given by HM Revenue & Customs include a 'slight detour' on the way to work to drop a child at school or buy a newspaper; attending a dental appointment on the way home; and occasional trips to take household rubbish to a tip. Examples given of private use which would not count as 'insignificant' include taking the van on holiday; regularly using it for supermarket shopping and any use for 'social activities'. However, outside of those published examples, it is in fact difficult to predict where HMRC will draw the line. (For example, can a driver pick up his child from school and take her to the dentist? Frankly, your guess is as good as ours - and HMRC staff have been expressly forbidden to expand on the published examples.)

Two final points. Firstly, although it is usual to call this the scale charge on 'vans', in fact it also applies to other small commercial vehicles, such as pick-up trucks. Secondly, the scale charge applies equally where a director uses a van owned by his own company. But where a self-employed person (or a partner in a business) uses a business van for private journeys, he or she will continue to be taxed on the appropriate proportion of the total cost of running the vehicle for the year. This avoids the 'cliff edge' liability for a substantial scale charge, but does not give any exemption for home-to-work mileage or insignificant private use.

**Purchases of equipment, machinery and vehicles** - Finally, remember that small businesses can claim 50% first-year allowances on almost all purchases of equipment and vehicles (other than motor cars) until 5 April 2007 (31 March 2007 for purchases by companies).

In practice most businesses qualify as 'small' for this purpose: you must satisfy at least two of the following three tests: annual turnover not exceeding £5.6 million, total assets not exceeding £2.8 million, no more than 50 employees.

*This newsletter deals with a number of topics which, it is hoped, will be of general interest to clients. However, in the space available it is impossible to mention all the points which may be relevant in individual cases, so please contact us for personal advice on your own affairs.*