



Hobsons
Chartered Accountants & Business Advisors

Hobsons : Newsletter November 2006

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This month we have information for shareholders lending money to their company, issues for property owners trading rather than investing, notes on tax and 50:50 ownership, and finally gifts and inheritance tax.

Don't forget to call if you need more information on any of the issues raised. The next newsletter will be published on Tuesday 5th December 2006.

What Next?

When did you last have the opportunity to stand back and try and evaluate where your life and your business was going? We are offering clients the facility of a FREE one on one session with a trained facilitator where, with the help of a specialised software product, you will be able to start to develop your own action plan.

A session will probably last just over an hour and at the end you will receive a full colour document recording your plan.

What can it help you achieve?

- Establish where you are now
- Identify what you really want
- See the bigger picture
- Focus on work/life balance
- Help you focus on financial independence
- Value what is important to you
- Create SMART goals
- Plan for your next steps to what you really want

In other words take a good look at your business and your life and help you plan for what you really want.

When was the last time someone offered you something for free? We are confident that should you sign up for a "Business Energizer" session you will find the time spent extremely useful and productive.

To register an interest and perhaps discuss this more fully please e mail Jean Willey at j.willey@hobsons.biz .

Shareholder loans to company

There are certain circumstances when it may be more expedient for a shareholder to lend money to the company rather than the company borrow money from its bankers. The shareholder could use his own savings or borrow funds to do this. If funds are borrowed we have listed below some of the conditions that must be met in order that the shareholder obtain tax relief on interest paid.

1. The shareholder must own over 5% of the ordinary share capital of the company, or have worked for the majority of their time in the actual management of the company.

2. The company must be a private company that meets specific criteria to qualify as a "close" company, and be a trading concern or involved in the letting of property to unconnected parties.

3. Tax relief will be denied to the shareholder if he funds the loan to the company by means of an overdraft. Interest is only allowed if charged to a loan account.

4. In order to obtain full tax relief the shareholder must have sufficient taxed income to cover the interest paid. If the interest is more than total taxed income the excess cannot be carried forwards to be set off in future years, or carried back to previous tax years.

In the event that the company is unable to repay the loan made by the shareholder the amount of the loss can be claimed for capital gains tax purposes. (CGT relief will only be allowed if the company applied the loan for the purposes of its trade.) This relief is also available to guarantors. For instance if a shareholder provided a personal guarantee to the company's bankers, which was called upon, then the amount paid to the bank would qualify as a capital loss.

If the shareholder is also a director care must be taken when funds are withdrawn to reduce an existing director's loan. Tax relief on the funding for the later shareholder loan may be reduced or lost completely.

Trading with property

If you have bought property as a long term investment, and have let accordingly, the rents received will be treated as investment income subject to income tax, and when you sell the property the gain will generally not attract business asset taper relief, nor be available for rollover relief. (Furnished holiday lets property is treated as being used in a trade and is an exception to this general rule regarding taper relief.)

There is also a particular situation where dealing in property can be considered a trade. The tax consequences can be interesting!

Property Developers

If you personally buy a property with the sole intention of realising a quick profit HMRC are likely to consider that you are a developer trading with property.

Negative tax and national insurance issues:

a. Any profit you make will be subject to income tax and you will lose the capital gains tax annual exemption, currently £8,800 per person.

b. It is also unlikely that HMRC would allow you to treat property bought and sold in this way as your home (principal private residence), even if you "moved in" for a few weeks while the property was refurbished.

c. To avoid a £100 fine you will need to register this trade within 3 months of commencement.

d. National insurance contributions will be due on profits made. Class 2 and Class 4.

Positive tax issues:

e. Losses made can be set off against other income. (Rental losses cannot be set off in this way).

f. The value of the business will attract 100% business property relief for inheritance tax purposes.

g. Pension contributions can be paid out of property development business profits and attract tax relief in the normal way.

As you can see there is both good and bad news to consider. Please call if you are considering this type of property deal, we can work out the best tax strategy to apply based on your individual needs. Leaving the call until after the event may well be too late!

Interesting tax consequences of a 50:50 split!

References in this article to husband and wife, also apply to partners subject to the Civil Partnership Act.

Inheritance Tax - Shares in Private Limited Company

The following two paragraphs provide an interesting example where the taxable value of a gift of shares may be less than the market value!

Consider a small trading company that has been valued at £1m. There are two shareholders Mr X and Mr Y who both own 50% of the issued share capital. Common sense would indicate that their individual shareholdings are worth £500,000. Whilst this would be the case should they actually sell the business, different rules would apply if they considered gifting their shares.

Inheritance tax looks to the value lost by the person making the gift, not the value gained by the person receiving the gift. If Mr X gifted his shares to his son, he would be transferring a minority interest. (51% is needed to exert control.) For valuation purposes a minority interest may be subject to a discount of between 20% to 30% of the market value. So a gift could be made worth £500,000 and be treated by the Revenue as valued at say £400,000 for inheritance tax purposes.

Income Tax - Property ownership and rental income

Should a property be owned by more than one person it is normal practice to agree the percentage share owned when the property is bought.

If our Mr X and Mr Y also jointly owned a rental property it would suggest that not only would they split the profit or loss on sale of the property equally, but would also share rental income arising from the ownership in the same proportion.

However the Revenue will accept a split of rental income at variance with the ownership of the property as long as all parties agree. So Mr X could be allocated 90% of the rental income and Mr Y 10%. This is a useful strategy to consider but it does not apply to a husband and wife who own a rental property.

In husband and wife situations it may be sensible for one party to receive the bulk of the rental income and pay tax at lower rates - thus creating an overall increase in post tax income for the family. But to gain the Revenue's approval the couple must own the property as tenants in common, and the percentage owned by each party has to be the same as the division of rental profits. So if Mr A and Mrs A own a rental property as tenants in common, 90% owned by Mrs A and 10% by Mr A, rental income and profits can only be split 90:10.

Income Tax - Husband and wife owned businesses

If a husband and wife team run a small limited company, or trading partnership, and each own 50% of the shares or rights to share of profits, they need to be mindful of the "settlements legislation" particularly where there are few assets in the business.

If Mr X owns 50% of the business but does 90% of the work in the business, the Revenue can use existing legislation to restore a commercial balance to the situation. In this example the Revenue could argue that as Mr X does 90% of the work then he should receive 90% of the dividends/share of profits distributed by the business.

This area of tax law is currently being tested by the Arctic Systems case, a House of Lords decision is pending. But as current legislation could be applied, shares of business income between husband and wife need to reflect the underlying commercial reality. A 50:50 split on paper does not prevent a challenge by the Revenue that other divisions should be applied.

Gifts and Inheritance Tax

Most taxpayers are aware of the term PET as applied to inheritance tax. (A Potentially Exempt Transfer.) If a gift is made from one individual to another as long as the person making the gift lives 7 years after making the gift, no inheritance tax is payable.

But what happens if the person making the gift retains some "enjoyment" of the gift made? We will need to consider the Gifts With Reservation of Benefits rules - otherwise known as "GWROB's".

When a person dies who has made a GWROB the value of the asset gifted will still form part of their estate for inheritance tax purposes. A classic example is where an elderly parent gifts their property to the children, but continues to live there. A GWROB can be avoided in this type of situation if the donor pays full market rent for the use of the asset gifted.

A PET can also be affected by further anti-avoidance legislation called POAT - "Pre Owned Assets Tax". Although the underlying legislation was enacted to counter complex avoidance strategies, the Pre Owned Assets Tax can also be applied to quite innocent situations. It generally applies to gifts that are converted to other assets which are subsequently used by the original donor - POAT can also be applied to transactions that were set up some time ago! For instance an elderly parent could gift cash to son who buys a house in his name. The parent then occupies the house rent free. A POAT is not an inheritance tax charge - it is a charge to income tax for the use of an asset.

The legislation for both GWROB's and POAT's are incredibly complex. However a gift can only be classified as a GWROB or subject to the POAT rules - not both.

We suggest that if you have unwittingly stepped into a GWROB or POAT type transaction that you call us to discuss the tax consequences without delay!

Tax Diary November/December 2006

1 November 2006 - Corporation tax due for companies with a tax liability for the trading year ending 31 January 2006.

19 November 2006 - PAYE and NIC deductions due for month ending 5 November 2006. (If you pay your tax electronically the due date is 22 November 2006)

1 December 2006 - Corporation tax due for companies with a tax liability for the trading year ending 28 February 2006.

19 December 2006 - PAYE and NIC deductions due for month ending 5 December 2006. (If you pay your tax electronically the due date is 22 December 2006)

30 December 2006 - If you file your 2006 Tax Return via the Internet you must send it back by this date if you want the Revenue to consider collection of outstanding tax for the year through your tax code. This will only be possible where you owe less than £2,000.

DISCLAIMER - PLEASE NOTE: The ideas shared with you in this email are intended to inform rather than advise. Taxpayers circumstances do vary and if you feel that tax strategies we have outlined may be beneficial it is important that you contact us before implementation. If you do or do not take action as a result of reading this newsletter, before receiving our written endorsement, we will accept no responsibility for any financial loss incurred.

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