Talking Tax

DRIVING LIFELONG PROSPERITY

Autumn 2016

SPOTLIGHT ON INVESTING

Welcome...

As usual, there are many changes happening in the world of tax. Some are already in effect such as the new investors' relief and the restriction on capital gains tax relief for Employee Shareholder Status. From April next year there will also be a raft of new rules to consider, including changes to the utilisation of carried forward losses, interest relief for companies and a new 'residential nil rate band' for inheritance tax. We delve into the detail of these changes and more in this issue of Talking Tax.

With a new Chancellor in place and the full extent of Brexit yet to be realised, we can only expect more changes to the UK tax regime in the near future. It will be interesting to hear what Hammond has to say in his first Autumn Statement in November.

INSIDE

→ The new investors' relief
→ Battle of the share schemes: ESS v EMI
→ Company corner
→ Entrepreneurs' relief and associated disposals – all change
→ Residential Nil Rate Band
→ Brexit and internationally mobile workers
→ Watch this space for

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The new investors' relief

During the Chancellors' last Budget speech in March, he announced that entrepreneurs' relief would be extended to benefit external investors of unlisted trading companies.

Delving further into the detail, it became clear that rather than an extension, he was actually introducing a new standalone relief, labelled as 'investors' relief'.

WHAT IS INVESTORS' RELIEF?

Investors' relief provides for a lower rate of capital gains tax (CGT) to be applied to disposals of shares in unlisted trading companies, where certain conditions are met.

Under the current entrepreneurs' relief rules, one of the main conditions is that the individual holding the shares must be an employee or officer of the company. Conversely, to qualify for investors' relief, the individual subscribing for the shares must not be an employee or officer of the company.

WHAT ARE THE RATES AND LIMITS?

CGT at a rate of 10% will be applied to qualifying gains compared to the current rate of 20% for higher and additional rate taxpayers.

Gains available at the 10% rate will be subject to a lifetime cap of £10million. This lifetime cap is in addition to the entrepreneurs' relief £10million cap. Therefore, up to £20million of gains could be subject to a CGT rate of 10% by a single investor across different investments.

CONDITIONS TO QUALIFY

To qualify for investors' relief, the shares must:

- be subscribed for (e.g. acquired as a new issue of shares by the investor);
- be in an unlisted trading company, or unlisted holding company of a trading group;
- have been issued after 16 March 2016; and
- have been held for at least three years prior to disposal (with the earliest date the three year period can be started from being 6 April 2016).

In addition, and as mentioned above, the individual must not be an employee or officer of the company, nor closely connected to someone who is (e.g. business partners, spouses, parents and children).

In the latest proposals, however, this requirement has been relaxed a little. Unpaid directors and certain employees will still be able to qualify for investors' relief providing:

- they had no previous connection with the company;
- there was no intention that the investor would become an employee from the outset; and
- they do not actually become an employee within six months of the investment.

WHO WILL BENEFIT FROM INVESTORS' RELIEF?

Advantageous tax reliefs can already be obtained by individuals when they invest in companies that qualify for the Enterprise Investment Scheme (EIS). The tax benefits under EIS include 30% income tax relief on the amount invested in the year of the investment (or the preceding year) and no CGT on disposals of shares held for at least three years. As the tax reliefs are not as beneficial under investors' relief it could be questioned how widely this benefit would be claimed. However, the conditions to qualify for investors' relief are much less stringent and it could also be useful for companies that do not meet the qualifying criteria under EIS but want to attract external investors. Similarly, investors who have already exceeded the limits for EIS could look to benefit from investors' relief.

For investors with lower income and smaller share portfolios the new relief may not offer any additional tax relief. This is because the newly introduced lower CGT rate of 10% (previously 18%) now applies for individuals who have not used their entire basic rate band with their income (i.e. total income of less than £43,000 for 2016/17). Also, each individual has an annual capital gains tax exempt allowance of £11,100 to utilise.

BATTLE OF THE SHARE SCHEMES: ESS V EMI

Employee share schemes can be a valuable tool to help recruit new employees and incentivise and retain existing staff. If structured correctly an employee share scheme can be a tax efficient and cost effective option to form part of the remuneration package offered. Tens of thousands of UK companies use employee share schemes and the number is growing every year.

Until recent years an Employee Management Incentive (EMI) was the most common share scheme structure implemented by our clients. However, with the introduction of Employee Shareholder Status (ESS), also known as 'shares for rights' in 2013, this had started to challenge EMI as a popular alternative. The main reason for this being a full CGT exemption on a disposal of shares issued under ESS.

In the March 2016 Budget, however, the Chancellor delivered a blow for ESS, announcing that the CGT exemption would be restricted to the first £100,000 of the gain on disposal. We take a look at whether this could block the use of ESS and situations where it could knockout its opponent, EMI, in a head to head battle.

ROUND 1 - A QUICK RECAP

As a reminder here is a quick comparison of the two share schemes:

	Enterprise Management Incentive (EMI)	Employee Shareholder Status (ESS)
Best suited to	Companies with fewer than 250 employees wishing to retain and incentivise staff.	Growing companies wishing to incentivise and retain staff.
Share reward or option	Option.	Reward – individuals must give up certain employee rights in return for shares.
Company restrictions	Must have gross assets of less than £30m and fewer than 250 employees. Must carry on a 'qualifying trade'.	None.
Monetary limit	£250k per employee up to a maximum total of £3m.	No upper limit but the shares must be worth at least £2k on issue.
Tax reliefs	No tax or NI on grant or exercise unless below market value. CGT due on disposal but likely to qualify for Entrepreneurs' Relief (e.g. 10% rate).	Income tax and NI payable on any award over £2k. £100k CGT exemption on disposal, unless the award was made pre 16 March 2016 where unlimited exemption applies, providing the shares were worth less than £50k when awarded.

ROUND 2 – HEAD TO HEAD

In some cases companies may not be able to meet the requirements of EMI, typically because they are too large or because they do not meet the 'qualifying trade' condition. For example, activities such as dealing in land, farming, legal and accountancy services and operating or managing nursing homes or hotels are all excluded activities. ESS, therefore, wins hands down in such cases as there are no similar company restrictions.

With a previously unlimited CGT exemption (providing the shares were valued at less than £50,000 at the date of issue), ESS was also a strong contender in the stakes of most advantageous tax reliefs. However, with this exemption now restricted to the first £100,000 of gains, it is now more likely to come down to points based on the specific circumstances.

As an example, if the individual will be holding more than 5% of the shares in the company, ESS could still be the way to go. This is because they would benefit from an exemption on the first £100,000 of the gain and any remainder could qualify for a 10% rate if structured appropriately such that it also qualified for entrepreneurs' relief.

Things start to get a bit more complex, however, where the shareholding is less than 5% and a crystal ball would be helpful here to determine what the potential gain could be on disposal.

ROUND 3 – IT'S A KNOCKOUT?

There is, unfortunately, no clear winner and the most appropriate scheme to implement will come down to the specific facts and circumstances of the business and its employees. Along with EMI and ESS there are a number of other share schemes that should also be considered.

We can help you to choose the right one, tailored to your business objectives and meet your employees' needs.

Company corner

There have been a few recent developments in the world of corporation tax with new proposed legislation set to come in from next year. Two of the key measures put forward are highlighted below.

INTEREST DEDUCTIONS – MORE RULES

Just in case there weren't already enough rules to restrict corporation tax deductions for interest expense, an additional layer of rules will be introduced from April 2017.

Existing rules such as transfer pricing and loans for an unallowable purpose must still be considered and applied first. Following this, if the proposed interest deduction for the year is greater than £2million, new interest rules must also be applied.

In broad terms, the new rules will seek to restrict interest deductions to 30% of "tax EBITDA" (based on profits chargeable to corporation tax but with certain exclusions).

The rules are complex and will need careful consideration, however, they are only likely to affect larger corporates in practice.

CARRIED FORWARD CORPORATION TAX LOSSES

Two changes are proposed from April 2017 that will impact on the utilisation of carried forward corporate tax losses:

1. **Increased flexibility** – losses arising after 1 April 2017 can be carried forward and offset against the total taxable profits of the company as well as the profits of its group members. Pre-April 2017 losses will continue to be treated under the old rules and hence trading losses created before this time will still have to be streamed for offset against the trade to which they relate.
2. **50% restriction** – Currently there is no restriction on the amount of carried forward losses that can be offset against current year profits. Under the new proposals each group will have a £5million annual allowance such that they can utilise carried forward losses up to that amount in a given year without restriction. After this, it will only be possible to offset carried forward losses against 50% of the remaining profit.

Given the £5million annual allowance, the restriction is only likely to apply to larger companies/groups. However, the increased flexibility could benefit groups of all sizes and prevent the issue of 'locked losses' (i.e. where a group entity has losses but no possibility of future profits) where created post April 2017.

Entrepreneurs' relief and associated disposals – all change

The government seem intent on tweaking the entrepreneurs' relief (ER) rules at every opportunity. In particular, the associated disposal rules have been targeted in recent times but with some unintended consequences. We look at the change in rules, what this means and the latest position.

WHAT IS AN ASSOCIATED DISPOSAL?

This is where a property (or other business asset) is held outside of a partnership or company by a partner or shareholder and is subsequently disposed of following a disposal of all or part of a partnership share/shares in the company. ER can normally be claimed on an associated disposal, resulting in a 10% CGT rate, providing certain conditions are met.

CHANGES

1. Minimum 5% share in the business

From March 2015, the partnership interest or company shareholding disposed of must constitute at least 5% of the business. Previously the legislation had referred to a 'material disposal' but this had no definition.

The associated disposal should be carried out as close to the partnership/share disposal as possible; however, HMRC do accept that there could be some delay, for example, to allow for the property to be marketed and sold.

If an individual had made a share or partnership disposal prior to 18 March 2015 of, say, 2% and were now looking to dispose of the property, they would not qualify for ER on the basis that under the new rules there was not a material disposal.

2. Three year period of ownership

In 2015 some anti-avoidance provisions were also introduced. These changes had some unintended consequences for certain commercial deals, which HMRC confirmed it had not been their intention to affect. The March 2016 Budget, therefore, introduced some further changes to deal with this. However, along with these changes, they have also sneaked in a new ownership requirement.

Previously, to claim ER on an associated disposal, the land had to be owned and used in the business for a period of at least 12 months. Under the new rules this period of ownership has increased to three years.

After representations from professional bodies and advisors a further amendment has since been made to the Finance Bill such that the three year ownership period only applies to assets acquired on or after 13 June 2016. Therefore, our current understanding is that if the asset disposed of was acquired before this date, they will only be subject to a 12 month ownership period.

WHAT'S NEXT?

Until the Finance Bill is passed, there remains some uncertainty; however, this is expected imminently.

If you hold a business asset outside of your company/ partnership and are looking to dispose of the asset, it is advisable to check your tax position first to ensure that you are not hit with a higher tax bill than expected.

Residential Nil Rate Band

From April 2017 the Inheritance Tax (IHT) Nil Rate Band (NRB) will be supplemented by the Residential Nil Rate Band (RNRB) when a residential property is left to direct descendants on death.

The RNRB will initially be worth £100,000 and increased by £25,000 per annum so that from April 2020 it is worth £175,000. For a married couple it will eventually be possible to leave assets worth £1million without paying IHT. However, if the value of a person's estate exceeds £2million the RNRB is tapered by £1 for every £2 over. The value of the estate is assets less liabilities, but before reliefs such as Agricultural Property Relief and Business Property Relief.

Where a taxpayer has more than one residence, the personal representatives can make an election to nominate which property is covered. Unlike for CGT, there is no restriction on the size of the garden or grounds nor a requirement that the property has been occupied as a residence throughout the period of ownership. Where a taxpayer has sold a residence after 8 July 2015, downsizing relief is available to ensure that assets representing the value of the residential property qualify for the RNRB. However, downsizing relief is limited to the RNRB available at the time of downsizing, and is currently £100,000.

For a property to qualify for the relief, it must be 'closely inherited' on death and left to a lineal descendant i.e. children or grandchildren or their spouse. This includes step, adopted and foster children. If the property is left on trust, the terms of the trust must give the lineal descendant a life interest or be a vulnerable beneficiary or bereaved minor trust for the lineal descendant. If property is left to a discretionary trust the RNRB will not be available.

Like the NRB, the RNRB can be transferred between spouses. The RNRB is available irrespective of when the first death occurred, as long as the second death is after 6 April 2017.

PLANNING OPPORTUNITIES

There are a number of planning opportunities to consider. The RNRB is tapered if the estate exceeds £2million, so husband and wife should equalise their estates as far as possible to ensure that both are valued at less than £2million. Where the combined estate exceeds £2million it may be appropriate to use a NRB trust on the first death to reduce the value passing to the surviving spouse.

The value of a residential property is calculated after deducting liabilities. If the net value of the property is less than the available RNRB it may be possible to increase it by restructuring the debt.

As mentioned above, an abatement of the RNRB will occur if the estate on death exceeds £2million. Gifts in the seven years prior to death are not included in the value of the estate for these purposes so there could be an opportunity for deathbed lifetime gifting, potentially protecting the RNRB. The gift will, however, still form part of the estate when looking at the IHT payable as it will be treated as a potentially exempt transfer (PET).

With all planning ideas, care should be taken to ensure that there are no unexpected tax consequences. Whilst the RNRB can potentially save £140,000 IHT and enables assets of up to £1million to pass free of IHT, there are plenty of traps for the unwary, and professional advice should be taken.

BREXIT AND INTERNATIONALLY MOBILE WORKERS

The 'statutory residence test' was introduced on 6 April 2013, which washed away all previous rules and case law applicable to an individual who has to determine whether he or she is resident in the United Kingdom for tax purposes.

The statutory residence test is notoriously complicated, and many are put off after an initial reading because of the sheer volume of detail. However, with some perseverance, the test provides far more certainty than it did when trying to apply previous HMRC guidance and court rulings.

Particular problems have arisen around the definition of 'home' and 'work' which features in some of the tests, and the legislation only vaguely defines this. In spite of, or perhaps because of, these uncertainties and various degrees of complexity, we are now into the fourth year of the statutory residence test and there have still been no cases heard at tribunal. We can only speculate as to why this may be, particularly given that this appears to be a difficult area. High on the list of possible reasons could be HMRC's policy of targeting its resources at areas where they perceive a significant loss of revenue to the Exchequer could be recovered with a minimum of effort. We would like to think enquiries have not been necessary because of the quality of the professional advice given!

THE REMITTANCE BASIS

There have been no significant changes to the statutory residence test itself since inception, although remittance basis users (those non domiciles who are allowed only to be taxed on monies they send to the UK), will have seen some expensive changes. Originally, remittance basis users who had been resident for at least 7 years had to pay a £30,000 charge for each year they wished to access it. A second, £50,000 charge was later introduced for those resident for more than 12 years, and then from 6 April 2015 this was increased by a further £10,000 to £60,000.

Also from 6 April 2016, those resident for at least 17 years face a £90,000 remittance basis charge, but further to current proposals which are anticipated to take effect from 1 April 2017, that £90,000 charge will effectively be made redundant, because the remittance basis will be removed as an option for people who have been resident for 15 out of the last 20 years.

IMPACT OF BREXIT

Depending on which side of the fence you sit, the announcement of the United Kingdom's exit from the European Union could cause either an outflow of individuals looking to flee to pastures new, or an influx of people looking to take advantage of the new opportunities Brexit will bring. In the case of both groups, the statutory residence test will take further prominence because it governs the taxability of those individuals and where their UK liabilities begin or end.

While many are still struggling to come to terms with the complexities of the test, we do not anticipate any changes as a result of Brexit alone. The legislation only makes such references as 'overseas', 'country or countries' and 'cross border' amongst other generic descriptions. Jurisdictions within the EU are not considered separately to any other overseas jurisdiction.

Some commentators have expressed concern over the need to rewrite certain double taxation treaties between EU member states and the UK. We see this as being unlikely; double taxation treaties are to encourage trade and are generally based on something known as the 'OECD model convention'. While the OECD includes a number of EU States, it also includes such countries as Canada, Mexico, New Zealand, Australia and the United States and is not meant to be limited to just the EU. Indeed the original OECD model convention is older than the EU itself.

While Brexit may now have caused politically and economically uncertain times, death and taxes (often both at the same time) are still certain, and the mobile workforce can continue to plan their tax residency as before.

WATCH THIS SPACE FOR:

HAZLEWOODS TAX VIDEOS

We are very excited to announce the launch of our first in a series of videos, following the Woods family who help to highlight just some of the tax services we can offer.

Our first video looks at employee share schemes, which can be a tax effective way to incentivise and retain staff without an upfront cash outlay for a company.

Look out for the first video, coming soon!

TAX INVESTIGATION SERVICE

Renewal invoices and new subscriber letters should be with you shortly (if not already) inviting you to subscribe to our Tax Investigation Service for 2016/17.

We recommend to all our tax compliance clients that they consider subscribing to the service which will cover our professional fees that result from most types of HMRC enquiry or investigation (full details are included in the Service Summary you will receive along with your letter).

Each year HMRC investigates hundreds of thousands of individuals and businesses, this could be at random and even if you have done nothing wrong. It can take a lot of time to answer all of HMRC's questions and queries, but by joining the service you will not have to worry about our fees.

If you have any questions about the service or if you would like to receive a discounted group quote or do not receive a letter in the next couple of weeks, please contact Fiona Rawle or Geraldine Lee on 01242 680000.

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