# Talking Tax

**DRIVING LIFELONG PROSPERITY**

Autumn 2018

## SPOTLIGHT ON BUY-TO-LET LEGISLATION

## *Welcome...*

to the autumn edition of Talking Tax. In this issue we reflect on some legislation changes introduced in 2017 for landlords of buy-to-lets and separately for corporate disposals as the rules for both have started to bed in. We also review the effect of two recent case law decisions on employment status and entrepreneurs' relief and, finally, we look ahead to changes for VAT and capital gains tax.

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# Landlords caught out by interest restriction rules

The 2017/18 tax year saw the commencement of restrictions to relief for finance costs of residential property. As tax returns begin to be prepared and filed for this period, we take a look at some unexpected results when applying the new rules.

## TAXABLE INCOME

Under the new rules, the tax is first calculated based on the property profits, excluding any restricted finance costs. A subsequent calculation is then carried out to apply a tax reducer at 20% (i.e. the basic rate) of the allowable finance costs.

As the finance costs are initially ignored altogether, this will lead to higher taxable income reported for landlords with property debt. The impact of this could include:

- basic rate taxpayers being tipped into the higher rate of tax;
- tipping income above £100k/£150k leading to a reduction in personal allowance or pensions allowance respectively; or
- tipping income above £50k leading to a reduction or loss of child benefit.

## THE 'TAX REDUCER'

Once the property income has been taxed, a tax reducer is calculated and applied. This is not, however, just 20% of the restricted finance costs.

It is instead calculated as 20% of the lower of:

- total adjusted income (which excludes savings and dividend income and is after deduction of personal allowance);
- total adjusted rental profits (i.e. rental profits excluding restricted finance costs); and
- restricted finance costs.

This calculation could lead to some strange results.

For example, a director of an owner-managed business receiving a low salary of, say, £8,000, dividends of £20,000 and rental profits (before finance costs) of £3,000 would have a figure of nil under 'total adjusted income' and would, therefore, not receive any tax reduction in the current year for the restricted costs. Instead, these costs would be carried forward for potential use in future years.

## ACTION TO TAKE

The impacts may not be significant for 2017/18 as only 25% of finance costs will be restricted, as described above. It would be worthwhile, however, looking at the position as at 2020 once the rules are fully phased in.

Planning opportunities could also be explored to help mitigate the effects, such as spousal transfers, partnerships and incorporation of the property business. Please speak to a member of the tax team if you would like further information on this.

# aSSEssing changes for subsidiary disposals

**April 2017 brought about some welcome changes to simplify the rules relating to disposals of corporate subsidiaries.**

This relaxation widened the net for disposals of subsidiaries, to enable more to benefit from the substantial shareholdings exemption (SSE), which provides for an exemption from capital gains tax on disposal of a trading subsidiary.

## A RECAP OF THE CHANGES

A summary of the conditions to be satisfied pre and post April 2017 are:

| Pre April 2017 | Post April 2017 |
|---|---|
| At least 10% of the company's ordinary share capital held for at least 12 months in the **two** years prior to disposal. | At least 10% of the company's ordinary share capital held for at least 12 months in the **six** years prior to disposal. |
| The investing company must be a trading company (or the holding company of a trading group) before and after the sale. | Investing company condition removed in its entirety. |
| The investee company must be either a trading company (or a member of a trading group) before and after the sale. | The requirement for the investee company to be trading immediately post sale has been removed, providing the disposal is to an unconnected party. |

## INCREASED FLEXIBILITY

The changes have brought about increased flexibility, with more groups now qualifying for SSE. This includes:

- Single subsidiary groups – the removal of the investing company condition means that a holding company with just one trading subsidiary will now be eligible for SSE.
- Trading status post disposal - the government has recognised that, post disposal of a subsidiary, it is often outside of the seller's control as to whether that subsidiary is trading. The removal of this condition for third party disposals will help to give more certainty of the tax treatment for the seller.
- Fragmented disposals - extending the substantial shareholding period from two to six years could help with piecemeal disposals carried out over a longer period of time.

## DISPOSAL ROUTE

With the removal of the investing company condition, the ultimate owner effectively now also has a choice on disposal route:

1. Dispose of the shares at the holding company level and realise the proceeds in the hands of the individual shareholders.
2. Dispose of the shares in the subsidiary and realise the proceeds in the holding company. This option may be particularly attractive where the cash is not needed and could be used as a vehicle to pass on wealth to the next generation.

# ZERO DIVIDEND PREFERENCE SHARES ARE 'ORDINARY' SHARES

A recent case (McQuillan) has ruled that preference shares with no dividend rights form part of the ordinary share capital of a company. For the taxpayer, this resulted in the loss of entrepreneurs' relief (ER) on the disposal of their shares.

ER provides a beneficial 10% capital gains tax rate on disposal but, to qualify for this, the shareholders must hold at least 5% of the ordinary share capital of the company.

In this case, when classifying the preference shares as ordinary share capital, the shareholders' holdings dropped below 5%.

The decision was a blow for some, as the courts overturned the original decision made by a lower tribunal court, which had ruled that the zero rate preference shares did not form part of the company's ordinary share capital.

If you have a small shareholding in a company of over 5%, which also has zero rate preference shares, it may be advisable to review the structure and confirm whether ER would apply on disposal, in light of this latest case.

Additionally, if you are looking to issue preference shares, the rights of the shares should be carefully considered to ensure that the ER position of founder shareholders is not compromised.

For groups of companies, this decision could also have an impact on determining whether group relief and consortium relief will be available, as these are also based on ordinary capital shareholdings. Once again, we would advise that the position is confirmed if there are zero rate preference shareholdings in the company.

# Self-employed plumber deemed to be a 'worker'

**A landmark ruling for employment status has been made in the case of Pimlico Plumbers Ltd v Smith.**

Mr Smith, a self-employed plumber, was deemed a worker under employment law. This entitled him to certain employment rights such as holiday pay and the right to bring a claim in respect of discrimination against the company. He had also originally argued that he was an employee, but this was dismissed by an earlier court and not pursued further.

## THE FACTS

A summary of the arguments put forward for and against 'worker' versus 'independent contractor' status included:

| Facts supporting worker status | Facts supporting independent contractor |
|---|---|
| Requirement to be available to work five days per week for a minimum of 40 hours. | Provision of own tools and equipment and could choose which jobs to attend. |
| Substitution only possible with another Pimlico operative. | Pimlico reserved no right to supervise work carried out by Mr Smith. |
| High level of control - required to wear Pimlico uniform with certain guidelines to adhere to regarding appearance and to lease a company van. | Self-employed and VAT registered, required to obtain his own personal indemnity insurance. |
| Contract included terms such as 'wages', 'dismissal' and 'gross misconduct' more consistent with an employer/ employee relationship. | Financial risks with regards to payment for work completed and responsibility for remedying any complaints out of his own pocket. |

## IMPACT FOR TAX PURPOSES

The case was in respect of Mr Smith's employment law status and not his status for tax purposes. Although one often follows the other, there are separate rules for each and differences can therefore arise.

A consultation is currently ongoing considering employment status for tax purposes and the outcome of this will not be affected by this ruling.

## ER ENQUIRIES ON THE UP

In recent times, we have seen an increased focus on entrepreneurs' relief (ER) enquiries by HMRC. As with all things tax, ER is not just as straightforward as claiming a 10% capital gains tax rate on business disposals.

There are a number of areas in which HMRC may look to challenge eligibility for ER including; whether the relevant conditions have been satisfied such as the 5% shareholding requirement (as discussed in our article - see left), the company's trading status, whether the claimant is an employee and we have also seen an increased scrutiny on associated disposals (i.e. assets owned individually but used within the business).

With such a valuable relief, it is important to consider eligibility for ER as early on as possible and certainly before any disposal. This will help to give comfort over the position taken and help to speed up any correspondence with HMRC, should they raise an enquiry.

# CGT payment window to be reduced for second homes

**Disposals of second homes and buy-to-let properties are normally subject to capital gains tax (CGT). Under current rules, this is generally reported and any tax paid under self-assessment i.e. by 31 January following the tax year of disposal.**

Depending on when the disposal takes place, residential property owners currently have somewhere between 10 and 22 months before CGT becomes payable.

Under new rules, to be introduced from April 2020, this payment window will be reduced to just 30 days.

As an example, under the current rules, a disposal completed on 10 April 2019 would not be subject to CGT until 31 January 2021. If, however, the individual disposed of a second property a year later, on 10 April 2020, the new rules would apply and CGT for that property would be due on 10 May 2020.

This is almost nine months earlier than payment would be due on the first disposal which occurred one year previously!

Some potential issues with the reduced payment window could include:

- Time to gather base cost and other information required to carry out the CGT calculation.
- The applicable tax rate to apply to the disposal – an estimate will likely need to be made of the individual's total expected income for the year.
- Other disposals in the same year – if a gain is made on a property disposal at the beginning of the tax year and then subsequently a capital loss is made on another disposal, there is likely to be an overpayment of tax which is unlikely to be repayable until the self-assessment deadline.


## INTANGIBLES – ANYTHING TO SEE HERE?

It has not been possible to claim amortisation relief for purchased goodwill since 8 July 2015. This previously provided an attractive incentive for purchasers to acquire trade and assets (as opposed to share purchases) as they could receive an annual corporation tax deduction for the amortisation of goodwill.

Instead, tax relief is now only given at the time of disposal. Along with goodwill, relief was also removed for other intangible assets including customer lists and unregistered trademarks.

Although the tax benefits are somewhat reduced since the change in rules, there is still an opportunity to claim tax relief on the acquisition of certain non-customer related intangibles. This includes patents, registered trademarks, registered designs, copyrights and know how. Any such assets should be clearly identified as part of a trade and asset sale and a value attached to these as part of the sale and purchase agreement where possible.

A consultation on the intangible fixed assets regime was released by the government earlier this year. This included comments that the removal of relief for goodwill has impacted on the UK's competitiveness for attracting overseas business and is out of line with typical international practice.

At the time of going to print, we are still awaiting the consultation response, so time will tell whether anything is implemented to make the regime more attractive once again.

# Making Tax Digital to go ahead for VAT

**From April 2019, all VAT registered businesses with a taxable turnover above the VAT registration threshold will be required to maintain digital records as part of HMRC's push towards Making Tax Digital (MTD).**

## TAXABLE INCOME

HMRC have now published the final version of the VAT Notice, elements of which have the force of law, which explains the changes that will come into effect from April 2019 in relation to the digital submission of VAT return information.

Some key points to note from the release are:

- The MTD rules apply from the first VAT period starting on or after 1 April 2019.
- With effect from 1 April 2019, any business whose taxable turnover is above the VAT registration threshold (currently £85,000) must be subject to MTD.
- A business that is not registered for VAT at 1 April 2019, but which is required to register from a date subsequent to 1 April 2019 because the taxable turnover for the previous 12 months has exceeded the VAT registration threshold, must comply with MTD rules for all VAT returns that it is subsequently required to make.
- A business that has voluntarily registered for VAT at 1 April 2019, will not have to follow the MTD rules at that stage, but can choose to do so voluntarily. If its turnover subsequently exceeds the thresholds from, say, the end of November 2019, then the business must follow MTD rules for any VAT period that starts on or after 1 December 2019.
- It is confirmed that there will be a 'soft landing' (i.e. a period of grace) for digital links in the first year. However, this will only apply to links between different software programmes, and will not apply to transfers to software solely for the purposes of submitting the return (e.g. bridging software), where transfers of data must be digital from day one.
- HMRC have published a list of software suppliers who are developing functional, compatible software and who have tested their products in HMRC's test environment: https://goo.gl/4AWtyV

The next step for all VAT registered businesses is to consider whether they have the systems and software in place and are ready to cope with the new requirements. With just seven months left to go, we would recommend a review of your processes and systems sooner rather than later.

# EMI SCHEME RECEIVES STATE AID APPROVAL

EU state aid approval is required in order for the government to offer the tax advantaged benefits of the Enterprise Management Incentive (EMI) scheme.

The Treasury failed to obtain state aid approval in advance of the 2018/19 tax year and, as such, we were left in a temporary hiatus for just over five weeks whilst waiting for this to be reinstated.

Approval was given on 15 May 2018 and, therefore, EMI schemes can continue to operate as previously; however, the question is what happens to those schemes for which options were granted or exercised in the interim period?

The government has implied, but not expressly confirmed, that the approval was granted retrospectively, commenting that 'no changes have been made' and that the EMI scheme 'continues to operate in the same way.'

As state aid rules only apply to companies and not individuals, it would appear that even if this is not the case, the only potential impact would be on corporation tax reliefs under the scheme and any employee tax benefits would be unaffected.

If, however, a 'belt and braces' approached is preferred, for absolute certainty, it may be possible to look at issuing replacement EMI options.

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