

PRACTICE UPDATE

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HOLIDAY OFFICE CLOSURES

The office will close for Christmas and New Year on Tuesday 23 December 2009, and will reopen on Monday 4 January 2010. **SEASONS GREETINGS & BEST WISHES FOR 2010!**

1. Beating The 50% Tax Rate?

Despite the recession, there seems to be much concern about the introduction of a 50% top rate of income tax from 2010-11 for individuals with taxable income above £150,000 in the tax year. It has been suggested that company owners could consider extracting more income in the 2009-10 tax year (e.g. by advancing dividend or bonus payments), so that the income is taxed at 40% rather than 50%.

However, what about unincorporated businesses? Self-employed individuals who are high earners (e.g. doctors, dentists, solicitors) will also be concerned about the proposed 50% rate.

Accounting dates

Many unincorporated businesses will have a year end other than 31 March. For profitable unincorporated businesses with a normal year end of (say) 30 September 2009 or earlier, consideration could be given to having a short accounting period to (say) 31 March 2010. This may help to maximise the amount of profits falling into 2009-10, rather than 2010-11.

Of course, changing the accounting date to (say) 31 March would result in a shorter time period between the profits being earned and the tax on those profits becoming payable. In addition, overlap profits brought forward would be utilised. It

would therefore help to ‘do the numbers’ and estimate the profits for 2009-10 after overlap relief.

There are also tax rules relating to changes of accounting date (ITTOIA 2005, ss 214-220), which need to be considered. For example, in the case of established businesses, there must generally have been no effective change of accounting date in the previous 5 tax years, or alternatively any such change must have been for commercial reasons, and HMRC must have been properly notified (s 217).

If the relevant conditions are not satisfied, the basis period for the year of change remains the 12 months ending with the old accounting date in that tax year.

Incorporation

The incorporation of the business is likely to become more attractive for many sole traders and partnerships. The possible benefits include the potential to pay dividends to eliminate NIC, income deferral and the spreading of income between spouses and family members.

However, one commentator recently pointed out that the potential benefits of incorporation are no secret to the Government, and that it could therefore be described as a ‘high risk tax strategy’!

It is certainly true that there are no specific reliefs on disincorporation. Thus if the Government lessen the tax benefits of operating through a limited company, some businesses could find themselves trapped within a corporate wrapper.

Other possible Government measures include the introduction of 'income shifting' provisions or the reversal of the decision in the settlements case *Jones v Garnett*.

Take care!

The Government's strategy for dealing with 'unacceptable' tax planning these days seems to be the introduction of measures with immediate (or possibly retrospective) effect, often following an announcement in the Pre-Budget Report. Any planning for sole traders and partnerships should therefore be undertaken carefully, and with potential future changes in mind.

2. Partnership Profit Shares

Retrospective tax planning would be a wonderful thing in many cases. For example, it would potentially be very useful if partnership profit shares could be adjusted after the year end based on the personal circumstances of the individual partners, particularly in the context of partnerships involving family members.

However, is retrospective tax planning involving the allocation of partnership profits actually permitted?

HMRC's view

The Partnership Act 1890 states that profits, losses or other income may be shared between the partners as mutually agreed from time to time.

For income tax purposes, the general rule is that a partner's share of profit or loss for a period of a trade carried on by a firm is determined in accordance with the firm's profit sharing arrangement during that period (ITTOIA 2005, s 850(1)). A similar rule applies for corporation tax partners in respect of corporate partners (CTA 2009, s 1262).

HMRC accepts that 'the sharing ratio need not be in proportion to contributions of effort or capital.' HMRC also state the following (BIM72055):

"The allocation of profits or losses for an accounting period cannot be varied retrospectively after the end of that accounting period."

HMRC cite the case *Bucks v Bower* (Ch D 1969 46 TC 275) in support of their approach ('Merchant banker. An ex post facto reallocation of profits cannot operate to redistribute the right to relief'). It was held in that case that a partner's profit share is fixed at the end of the year, and cannot subsequently be altered retrospectively by agreement.

However, other case law suggests that profits may be allocated at a later time. In *Franklin v CIR* [1930] 15 TC 464, the partner of a firm died. He nominated his son to succeed him as a partner under the partnership deed. The other partners could refuse to admit a successor on reasonable grounds. The consent of the remaining partners was eventually refused. The deceased partner's profit share had been allocated to a suspense account in the meantime. If the son had been admitted, that profit share would have belonged to one partner (Partner A). Otherwise, it fell to be divided between the four partners at death. The profits were actually allocated to two partners (the other two partners having retired), on a 75:25 basis. The Court held that Partner A was assessable to super-tax only on the 25% to which he was entitled in any event, and that for the other partner there was no liability.

This case presents interesting issues where, for example, a partnership agreement provides for the reallocation of profits after the end of an accounting period. However, HMRC's views seem to be unequivocal, and cannot be ignored.

Property 'partnerships'

The joint letting of property will often fall short of being a genuine partnership. In

the case of husband and wife lettings, there may be some scope to reallocate property business profits in certain circumstances, although this must be dealt with in advance rather than retrospectively.

As a general rule, property income held jointly is divided 50:50 between a married couple (or civil partnership) living together (ITA 2007, s 836(2)). However, if the couple are beneficially entitled to the income in unequal shares (e.g. 90:10) they can make a declaration to be taxed in accordance with those interests, rather than on the normal 50:50 basis.

The couple can decide whether to make this declaration on an asset by asset basis (ITM142), but must do so within 60 days from the date of the declaration, in relation to income arising on or after the declaration date (ITA 2007, s 837).

3. Transferable Nil Rate Band

The introduction of the Inheritance Tax (IHT) transferable nil rate band facility in Finance Act 2008 has made life much easier for married couples (and civil partners) in terms of enabling the nil rate band to be utilised on the first death.

In certain circumstances, up to four nil rate bands may be available. For example, a co-habiting couple who have been married before may each have their own nil rate band, and also an unused nil rate band from their deceased spouses. However, the position could worsen if the co-habiting couple decides to marry.

Example

Edith is a widow who inherited an estate of £750,000 from her husband. Frank had also inherited his late wife's estate of £800,000. Edith and Frank met whilst on holiday, and set up home together. If they remain together but do not marry, there are potentially four IHT nil rate bands available, i.e. their own nil rate bands and those of their deceased spouses.

In the above example, what if Edith and Frank decided to get married? Frank wishes to make an IHT-efficient will. He has a 'double' nil rate band, but cannot pass this to Edith, who already has the additional nil rate band transferred from her first husband. Frank will waste his double nil rate band if he leaves his estate to Edith.

Frank could consider including a legacy to chargeable beneficiaries on the first death (e.g. to other family members and/or a discretionary trust), sufficient to use his own nil rate band plus the transferred nil rate band from his first marriage.

If Frank's double nil rate band passes to a discretionary trust, it should be remembered that such trusts attract IHT charges (e.g. 10 year anniversary and exit charges). The trust could only benefit from a single nil rate band for the purposes of calculating these charges. Frank may therefore wish to create 'pilot' trusts (i.e. trusts set up with a nominal amount of cash) during his lifetime. He could then leave funds to those trusts in his will.

Pilot trusts

The potential benefit of pilot trusts is that each trust may have its own nil rate band. Subject to the value of the trust property, it may be possible to avoid IHT charges arising within them. This is because of the way in which IHT is computed for 'relevant property' trusts, particularly where a settlor has a full nil rate band available.

However, care is needed when creating pilot trusts, for example to avoid the IHT rules regarding 'related settlements' in IHTA 1984, s 62 (i.e. settlements created by the same settlor on the same day). Thus two or more pilot trusts could be created consecutively with nominal sums over a period of time. If further funds are subsequently added to the pilot trusts on the same day (e.g. under Frank's will on death, in the above example), the IHT rules for 'added property' provide that the availability of the nil rate band in each pilot trust should be unaffected (IHTA 1984, s 67(3)(b)(i)).

As mentioned, it is important to ensure that the settlor's nil rate band is unused when the pilot trusts are created, and also that no further gifts or transfers are made between the trusts being created and death, because of the way in which IHT charges operate for trusts. Specialist advice is recommended, based on the specific circumstances.

4. Pension Contributions

It is not uncommon for assets to be transferred to pension schemes instead of cash. However, are assets an acceptable form of pension contribution to a registered scheme for tax relief purposes?

HMRC guidance categorically states in the context of employer contributions: "In-specie contributions are not allowed. The legislation only permits monetary contributions" (RPSM05102035).

However, the same guidance then goes on to indicate when the contribution of an asset may be acceptable. It broadly states that there must be:

- A 'clear' obligation on the employer to contribute a specified monetary sum (e.g. £10,000), creating a 'recoverable debt obligation'.
- A separate agreement between the scheme trustees and employer to pass the asset to the scheme for consideration.
- Acceptance by the trustees that the cash debt may be offset against the consideration payable for the asset.

In terms of member contributions, HMRC states that contributions to a registered pension scheme must be a monetary amount (e.g. cash, cheque, direct debit, bank transfer) but then says; "...but what is allowed is for an individual to agree to pay a monetary contribution by way of a transfer of asset(s)."

Stamp Duty Land Tax & Stamp Duty

However, does an in-specie pension contribution as described by HMRC create a stamp duty or SDLT liability? For

example, if the chargeable consideration for a land transaction consists of the satisfaction of a debt due to the purchaser, the debt amount is treated as chargeable consideration. A similar rule applies for stamp duty purposes (e.g. in relation to shares).

The position is not altogether clear, and the CIOT has requested clarification from HMRC on this point. However, based on HMRC's view that a cash debt must be created for tax relief to be available for a pension contribution which is satisfied by the consideration payable for the asset, it seems likely that stamp duty land tax or stamp duty liabilities would arise.

Date of Payment

A further issue regarding pension contributions in specie is in establishing the date on which the contribution is 'paid' for tax purposes. HMRC's view is understood to be that the time of payment is when the debt set-off actually takes place (i.e. when the pension scheme receives the asset value to set off against the pension contribution 'debt'. For a land transfer, this would be the completion date, or for a share transfer this would presumably be when the stock transfer form was dealt with.

Further issues potentially arise. For example, even if the in-specie pension contribution is acceptable, there are limits to the amount of tax relief available. In the case of companies there is also the question of the timing and extent of tax relief from business profits.

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