money matters

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CHARTERED ACCOUNTANTS

Alliott Group
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This newsletter is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking any action on the basis of the contents of this publication. The newsletter represents our understanding of law and HM Revenue & Customs practice as at October 2012.

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The many layers of VAT

VAT can easily give even the most seasoned of tax experts a headache, and the fact that European Union VAT rules take precedence over UK law just adds to the complexity.

Take the 'simple' matter of buying a sandwich. When you buy a sandwich from a sandwich shop or other fast food retailer you will be charged VAT if you want to eat it on the premises.

The European Court of Justice (ECJ) has recently ruled that where the level of service involved is minimal, then VAT should not be charged on cold food sold for immediate consumption even if it is 'eaten in'. Sandwich chain Subway has filed a test case against HMRC, and many other retailers are expected to follow suit.

Toasties and chickens

Subway is also involved in the continuing fallout from the 'pasty tax'. The tax charge on pasties was dropped, but toasted sandwiches are subject to VAT. Subway hopes to have the issue debated in Parliament, and has recently appealed a 2010 case decided in HMRC's favour.

Subway argued that its sandwiches must be served toasted in order to comply with food safety regulations. The decision again went HMRC's way, but Subway may take the case to the Court of Appeal. Not to be outdone, Morrisons supermarket is organising a campaign to reverse the 20% VAT charge that now applies to rotisserie chickens.

The company argues that the majority of its customers make purchases to eat later, rather than as take-away food.

Bad debt relief

The outcome of another conflict between UK and EU law means that businesses may now be able to claim VAT refunds on bad debts going back nearly 40 years. VAT bad debt relief can generally be claimed once a debt is more than six months overdue, but the conditions were once much stricter – the customer had to be insolvent, and a retention of title clause precluded any relief.

In a case brought by BT and General Motors' finance arm, the Tribunal ruled that the conditions previously imposed were not compatible with EU law. This means that refunds can be claimed for the period between 1973 (the year VAT was introduced) and 1997 (when VAT bad debt relief rules were rewritten).

Given the amounts involved HMRC is likely to appeal, possibly to the ECJ. We can help with a submission of a historic bad debt relief claim if your business is due a refund, although one practical difficulty could be finding the documentation after all this time.

Energy-efficient products

If all that isn't enough, there is one more conflict that could well end up in the ECJ. As part of its drive to reduce carbon emissions, the Government introduced a reduced rate of VAT of 5% for energy-efficient products, such as draught insulation and solar panels.

The European Commission has said that such a supply is beyond the range of items for which the reduced rate is permitted, and therefore the standard rate of 20% should be charged instead.

The Government disagrees with the Commission's findings, but will study the arguments before deciding on how to proceed.

A bit more certainty on residence

The Government plans to introduce its new statutory residence test (SRT) from April 2013. This should make it much easier for you to establish whether or not you are a UK resident if your residence status is currently unclear.

HMRC will provide an interactive online tool so that individuals can self-assess their residence status, and a prototype is already available. The aim of the SRT is to ensure that an individual cannot become non-resident without reducing their UK connections, but it recognises that people should not be treated as resident where they have little connection with the UK.

There will be some situations where a person is always treated as UK resident – if they stay here for 183 days or more during a tax year, if their only home is in the UK, or if they work here full-time. In other situations, a person will be automatically treated as being not resident in the UK, for example, staying here for fewer than 16 days in a tax year or leaving for full-time work overseas. The 16-day condition increases to 46 days if a person has not been resident for any of the three previous years.

If your status is not definite, then residence will be determined by a trade-off between connection factors and 'days of presence'. It will be harder for someone leaving the UK to relinquish residence than for a new arrival to acquire it.

Days in the UK	Coming to the UK	Leaving the UK
16 to 45	Not resident	Resident if 4 factors apply
46 to 90	Resident if 4 factors apply	Resident if 3 factors apply
91 to 120	Resident if 3 factors apply	Resident if 2 factors apply
121 to 182	Resident if 2 factors apply	Resident if 1 factor applies

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Connection factors are:

- Having immediate family here;
- Having UK accommodation (made use of during the year);
- Doing substantive work here (40 or more days a year);
- A UK presence in either of the two previous tax years (more than 90 days); and
- Spending more time here than in another country (only relevant for leavers).

The SRT will therefore be particularly welcomed by people who leave the UK without making a clean break – for example, where a house is retained.

Income tax reliefs: will the cap fit?

The Government recently launched its consultation on capping unlimited income tax reliefs.

As announced in the March 2012 Budget, an individual will only be able to claim reliefs up to the higher of £50,000 or 25% of their income.

The cap will only apply to those reliefs that are offset against a person's general income and which are not currently capped, but it will not apply to reliefs related to charitable giving. So it will mainly apply to certain loss reliefs and relief for qualifying loan interest, although the ability to carry forward trading losses against future trade profits is not affected. The most important losses that could be restricted are:

- **Trade loss relief** – claimed against income (and potentially chargeable gains) for the loss making year and/or the preceding year. Any restricted loss can still be carried forward.
- **Early trade losses relief** – a loss made in the first four years of trading can be set against income for the preceding three years. Any restricted loss can still be carried forward.
- **Share loss relief** – available for what would otherwise be a capital loss on the disposal of shares in unquoted trading companies. Relief is available against income for the year of the disposal and/or the preceding year. Any restricted loss can still be used as a capital loss and set against chargeable gains.

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The first tax year to be affected will be 2013/14, but the cap could apply to earlier years if a loss made after 5 April 2013 is carried back. When calculating the 25% limit, the income figure used will be adjusted so that individuals making pension contributions and/or charitable donations are all treated the same regardless of how these deductions are given. The cap itself will apply to each year relief is claimed.

The other relief most affected will be qualifying loan interest, including where money is borrowed personally for use in the borrower's company. Relief is only available against income for the year that interest is paid, and will be lost if the cap applies. This might mean having to reorganise how a business is financed, with the company borrowing money rather than the individual.

The proposals may yet change, but if you think you might be affected, please get in touch to discuss what can be done to minimise the impact.

‘Wholly and exclusively’ deductible?

To be deductible, an expense must be ‘wholly and exclusively’ for trade purposes. This sounds simple enough, but the definition of ‘wholly and exclusively’ has been the subject of endless dispute between businesses and professionals and HMRC.

If a cost can be found to have a ‘duality of purpose’, it will invariably mean that an expense is not allowed. The famous case of *Mallalieu v Drummond* concerned a barrister who failed in her claim to deduct the cost of her clothing as a business expense, although she could not appear in court without it. But the clothing also kept her warm and clad, so the expenditure was found to have a dual purpose.

This reasoning also applies to other everyday expenses like food, medical costs (even to treat work-related conditions) and rent or mortgage payments, even if working from home saves on travelling time and allows the taxpayer to do more work.

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Two recent cases concerning legal fees incurred by businesses show just what a grey area the definition of ‘wholly and exclusively’ can be. In *Linsdale Post Office & General Store v HMRC,* two brothers in partnership defended a claim by their sister that she should be an equal partner because she had allegedly contributed capital.

The Tribunal’s decision was that the brothers’ legal fees were an allowable business expense because they were incurred while defending the business’s assets. This follows the general principle that money spent is deductible if it is with a view to preserving the existing business, its goodwill or assets. The payment simply maintains the existing position, without addition or improvement.

However, a few days later, the opposite conclusion was reached in the case of *Purolite International Ltd v HMRC*. The company’s owners – two brothers and a US company – faced large legal fees as a result of the US company supplying goods to Cuba in contravention of US law.

Purolite contributed towards the US company’s costs, on the grounds that it risked losing its exports to the US if the case was lost.

On appeal, the Tribunal held that Purolite’s involvement in the case had a ‘dual purpose’ – not only were the brothers safeguarding their export business, they were also defending themselves from criminal charges – and so the fees were not a deductible expense.

In an area of such conflicting precedents, always seek expert advice.

UKBA gets tough on employers

Employers have been put on notice that the UK Border Agency (UKBA) is cracking down on illegal workers in the UK and is holding employers accountable for any failure to check their employees' visa status.

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The UKBA has just published new information and guidance for employers and expects full compliance. Whether your organisation employs highly paid executives or part-time students it is important to be fully aware of these employer responsibilities. Even top companies such as Tesco are not immune, and the resulting bad publicity may be more damaging than the penalties that are imposed.

During a recent UKBA investigation, around 20 foreign students of 11 different nationalities were found working between 50 and 70 hours a week at one of Tesco's warehouses. The current UK visa regulations allow foreign students to work only 20 hours a week during term time. The operation was part of an ongoing campaign to tackle visa abuse, which has resulted in over 2,000 offenders being deported in just five months. The potential fine for the employer is £10,000 for each illegal worker, with criminal prosecution also a possibility. So it is important to ensure that all of your employees have the right to work in the UK and that you comply with any restrictions.

A potential employee's documents should be checked before they are employed. If a person has a time limit on their right to work, then the document check should be repeated at least every 12 months. Where there are restrictions as to the type of work that a person can do or the number of hours they can work, these work conditions must not be breached. The UKBA website provides detailed guidance for employers. As Tesco has found out, students can be a particular problem. The rules have changed several times in recent years, and will vary according to when a visa was issued.

At the opposite end of the pay scale, listed companies could face fines and other sanctions under EU plans to ensure that 40% of non-executive board seats are occupied by women – compared to less than 14% at present.

The proposal has yet to be formally introduced, and is being strongly opposed by the UK and several other countries. It would apply to employers with more than 250 employees or £40 million of turnover and would be operative by 2020.

Dividend or bonus?

Right now is a good time for companies with a year-end of 31 December to decide if any further company profits should be withdrawn, and, if so, whether it should be done by way of dividend or a bonus.

If your aim is just to minimise tax, taking a dividend is now always more tax-efficient – especially if your company pays corporation tax at the 20% rate. With that in mind, let's crunch some numbers: the table shows how much cash you would take home from withdrawing an additional £10,000 of profit given different levels of personal income (assumed to be entirely director's remuneration), and a 31 December year-end.

Personal income	Corporation tax at 20% rate		Corporation tax at marginal rate (25%)	
	Bonus	Dividend	Bonus	Dividend
£25,000	£5,976	£8,000	£5,976	£7,438
£50,000	£5,096	£6,000	£5,096	£5,579
£200,000	£4,218	£5,111	£4,218	£4,752

The difference is most marked where personal income is £25,000, since at this level employee NICs at 12% come into the mix. Dividends also come out on top when the timing of tax liabilities is considered. For a bonus paid in December the related PAYE/NICs will be due on 22 January 2013. A dividend will fall into the 2012/13 tax year, so any additional liability is not due until 31 January 2014.

So is the case for dividends cut and dried? Not quite, as paying a bonus can have some advantages. Firstly, dividends must be paid in proportion to shareholdings – fine if you own 100% of the company, but it could cause problems where this is not the case. Then there is the problem that dividends do not count as pensionable earnings, which is not an issue if you already have sufficient earnings for your pension requirements, or if the company is making contributions on your behalf. Please contact us for advice.

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