

How to avoid the 50% tax rate

We have been receiving far more calls than normal in the wake of the Budget, as people earning more than £150,000 attempt to avoid the controversial new top rate of tax. While many, especially the super-wealthy, are considering leaving the country, others nearer the tax limit are already planning less drastic ways of reducing their tax bills.

There is no straightforward way for these high earners to avoid paying tax of 50% on their earnings above £150,000 when the new rules come into force in a year's time. However, we are advising clients on a variety of options.



Whilst there is no scheme that will fix it, the most potential we can see is converting income into capital. From April 2010 income tax will be 50% for high earners, but capital gains tax is remaining at just 18% - or 10% for the many shareholders in private companies.

Practically, this is likely to involve high earning employees taking some of their pay in shares in the company, rather than cash in the hope they can sell the shares at a later date at a profit, and pay tax at just 18% on the gain. That is not an option for owner-managers and the self-employed, however. In those cases, transferring the business to company and being rewarded by dividends rather than a salary is likely to be increasingly attractive.

Dividends, currently taxed at 25% for high earners, will become taxed at 36% but this is still much lower than 50% income tax level. We expect entrepreneurs and company owners to reduce their salaries to £150,000 and pay as much as possible through dividends, especially to family members who may be shareholders.

This means that, for many, the 50% rate is not inevitable. Another article in this issue explains profit retention within a company could limit tax to just 21% on surplus income. This will only work for those people who do not need to pay themselves a large salary, but is expected to be a popular option.

Another option is to send your spouse out to work! Couples with one earning £300,000 for instance and the other staying at home could reduce their total tax bill by £75,000 if they both worked and earned no more than £150,000.

So, although there is no easy way for high earnings to avoid paying 50% tax on earnings over £150,000, the options are as follows:

1. If you own, or have a stake in a company, pay yourself in dividends - if the company can afford it. Dividends for top-rate taxpayers will be taxed at 36% from next year, or 32% if you earnings remained below £100,000

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"Your application to borrow a Biro has been turned down"

2. Ask to be given share options in your company, which will give you the ability to convert income into capital gains taxable at somewhere between 10% and 18%
3. If you are self-employed incorporate yourself as a company and pay tax of between 21% and 28% on any profits you make
4. If you are a partner in a firm, be it an architect or lawyer, make sure you appoint a "corporate partner" into which can be allocated a proportion of the firm's profits

Although partners in the firm may still suffer income tax of 50% on some of their profit share, to the extent that the firm's profits that are reinvested back into the company will be taxed at between 21% and 28%, not 50%. This tactic also allows the conversion of income into capital gains if the corporate partner is subsequently wound up through a solvent liquidation.

Small firms likely to retain profits

One of the consequences of Darling's 2009 Budget is that it will encourage many family businesses to leave surplus funds in their companies. At present, it makes sense to take money out of companies using dividends as these only attract a 25% rate of income tax and doing so enables individual shareholders to diversify their investments.



When this money is reinvested in savings products any interest earned will be taxed at 40% for higher rate taxpayers, or 50% for those earning over £150,000 from next April.

Following the Budget, the cost of paying out surplus funds as dividends rises to 36.11%, Mr Herring said. This makes it more attractive to leave the money in the company and then invest it in the same way. Any income generated is then taxed at either the smaller company rate of corporation tax, currently 21%, or the larger company rate of 28%.

When we last had such a stark difference between the rates of tax on retained profits in a company and distributed profits, the Revenue felt that it had to have rules to force distribution. Hopefully we will not see those horribly complex tax rules come back again.

Saying "arrivederci" to your UK tax bill

The announcement in the recent Budget of a 50% tax band and higher taxes for anyone with an income over £100,000 will have prompted many people to consider leaving the UK when they retire, if not before.

If you leave the UK you can take your pension with you. The introduction of the qualified registered overseas pensions scheme ("QROPS") rules in 2006 has offered emigrating pensioners an attractive list of benefits when they move their plans offshore. These include improved death benefits, no compulsion to buy an annuity and freedom to invest in residential property. You can also pass on your pension fund and death after the age of 75 while avoiding the 82% tax levied by the British government.



QROPS schemes require the provider to report dealings with in your fund to HMRC for five years. After this there are now reporting requirements. There can be pitfalls, however. By taking your pension offshore, you are subject to the tax and pension rules in that jurisdiction. If you first draw your pension in France you won't be allowed any tax-free element - in contrast to the 25% available in Britain.

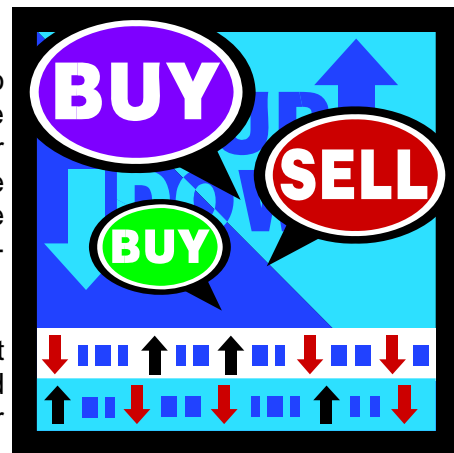
As regards your state pension, it is only if you emigrate to countries within the EEA or one of those with which Britain has a reciprocal agreement that you receive the annual increases in the state pension. These include Barbados, Bermuda, Jersey and Guernsey, but not Australia, New Zealand or Canada.

The timing of your departure from the UK and your arrival in your new country of residence can have a massive impact on your total tax bills. If you are planning to move will retire overseas, it is essential that professional advice is sought at an early stage.

Becoming a Lloyds Underwriter

About 20 years ago, the iconic London insurance market came close to collapse in a scandal connected to its main investor base - private individuals referred to as "Names" who had unlimited liability for insurance losses. The scandal, deriving from asbestos claims in the US, was so far-reaching and damaging that commentators of the time alluded to it as coming close to wiping out a swathe of British society - the upper-middle class.

Now, Lloyd's of London and the few firms still selling investment opportunities to private investors believe the wholesale reforms and regulation undertaken to save the market from oblivion makes it a near oasis of calm in the current financial crisis.



Lloyds is possibly one of the most tightly regulated financial markets in the world and the introduction of limited liability for private clients as well as other safeguards makes it increasingly attractive to investors looking for security among all the carnage happening in other parts of financial world. Those looking to enter the Lloyd's market and make money by underwriting risk can do so by either becoming a Name - now with limited liability - or by joining a group of private investors in a limited liability partnership. Those taking the plunge should be prepared to part with at least £300,000 and wait up to nine months before they can start underwriting. As for seeing the fruits of an investment, investors should be prepared to wait three years before receiving a return, because of the three-year reporting regime at Lloyd's.

One of the big attractions of investing in Lloyd's is the double use of assets. A contribution to a limited liability partnership can be capitalised with a bank guarantee secured on a portion of the investor's existing assets. Investors use existing equity portfolios, property, mutual funds and cash to secure a trading position at Lloyd's and retain an income stream on the underlying assets while also benefiting from insurance gains. In addition, it can mean a degree of further diversification within the investor's portfolio.

Tax benefits of becoming a Name, or entering a partnership, are potentially enticing. Lloyd's of London is one of the few places where sideways loss relief is still allowed, so trading losses can be set against other income and gains, something that is particularly appealing in the current environment. As Lloyd's investments are classified as a business asset, 100% Inheritance Tax relief is also available to UK taxpayers.

Although tax advantages are welcome, it is the performance of Lloyd's of London's investments that is driving private client interest. There are reports of average returns of over 25% per annum between 2002 and 2007. The three-year reporting regime means that 2008 results will not be known until later this year.

The more cautious investor looking at the insurance market may take the view that he could gain similar access by direct equity investment in listed companies such as Prudential or Axa. Even after all the regulatory improvements at Lloyd's, investors should still be wary. Personal liabilities may now be limited, but there remains the risk of losing everything invested. Some would say it's a market only for the very bold or the extremely wealthy. If you feel like taking the chance, please give us a call for more information.

'Bandit' Burt Reynolds makes list of top tax evaders

Smokey and the Bandit star Burt Reynolds could soon be feeling the long arm of law for real, after being named in California's list of top tax evaders. The Cannonball Run actor owes the taxman \$225,000 according to the annual list issued by state controller of taxes, John Chaing. Another celebrity with a large outstanding tax bill is singer Dionne Warwick, who owes \$2.18m. However, one "celebrity" that has managed to drop off the list is former American footballer O.J. Simpson, now earning a lot less as he spends time in prison for leading an armed holdup.



Debt Relief Orders

The Debt Relief Order (“DRO”), a new low-cost insolvency procedure, hit the statute books last month. They allow someone with little or no income, and debts of less than £15,000 to ask the Official Receiver to write off their borrowings. Applications are made to the Insolvency Service via an approved debt adviser.

An order lasts for 12 months, during which period any creditor named in the order can only take action to recover the debt if they obtain authority from a court.

If the debtor’s circumstances remain unchanged after a year, the debts are written off and the debtor is discharged. An applicant’s assets should not exceed £300 (excluding an additional allowance for a vehicle) and disposable income must be no more than £50 a month after tax, national insurance and reasonable household expenses.

With soaring unemployment and the collapse of many owner-managed businesses, the number of insolvencies in England and Wales could rise by about 40% this year to more than 150,000.

DROs will bring new people into the insolvency system, people with very little income, no assets and debts of £15,000 or less. Until now, they are the sort who would have made token payments on their debts or simply laid low until the six-year limitation on debt enforcement was passed.

There are number of controversial features of DROs:

- Court approval will not be needed. An Official Receiver can agree a DRO without any Court considering the application.
- For someone seeking a DRO, the first point of contact will be Citizens Advice or some similar non-profit organisation, raising the spectre of untrained staff being taken in by serial debtors.
- The local Official Receiver, who has the final say, will be presented only with online information compiled by the non-profit organisation. Only by monitoring failure rates of DROs proposed by each organisation will Official Receivers be able to identify lax monitoring of debtors’ representations.
- For creditors, the introduction of DROs could mean writing off at least £1.1 billion in consumer debt in 2009.



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Non-doms confused by taxman

New guidance on the controversial issue of tax rules for ‘non-domiciled’ residents in the UK is confusing and could result in people paying too much tax. HM Revenue & Customs’ 400-page guidance, published last month, outlines tax rules for self-assessment taxpayers who classed as non-domiciled in the UK. The rules came into force on 6 April 2008. Some of the guidance appeared to introduce rules or take a harder line on non-doms than had originally been thought or established through case law. Industry specialists have criticised the new a guidance as “too much and too late - as well as being potentially misleading”.



Furnished holiday lets

The beneficial tax treatment afforded to Furnished Holiday lettings (FHL) in the UK extends to favourable treatment of losses - permitting them to be set against other income in the same way as trading losses - and capital gains tax, meaning that FHL properties are treated as trading rather than investment properties, attracting Entrepreneurs' Relief, roll over relief and other business CGT reliefs. FHL profits also count as pensionable income. Owners can also claim capital allowances on equipment and furniture, which is not possible in respect of investment properties.



It is now apparent that the restriction of this beneficial treatment to properties in the UK rather than the European Economic Area is likely to be contrary to European law. HMRC now accept this point, but as a result will be repealing the Furnished Holiday Letting rules (including those applying in the UK) with effect from April 2010. This is no surprise, as otherwise they would be flooded with claims on foreign holiday homes which meet the FHL rules - however, these are fairly restrictive and do include provisions regarding the extent of letting to third parties.

There is scope for those who have made gains on the disposal of foreign holiday property in the past to now claim a lower rate of tax on gains they have realised. Looking forward, however, any tax planning that was based on the use of FHL will need to be revisited.

Refunds of overseas VAT

From 1 January 2010 claims for VAT incurred in other EU Member States will be made electronically to HMRC in the UK. The deadline for such claims is being extended from 6 months after the calendar year end to 9 months after the calendar year end. Member States will then be required to repay the VAT within 4 months unless further information is requested.

Overseas businesses incurring VAT in the UK will make claims through electronic systems in their Member State.



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More “transfer pricing” enquiries

Amid expectations that a long-anticipated judgment in the Dixons (DSG International) transfer pricing case is to be published, rumours are circulating that the taxman is set to increase the number of transfer pricing investigations. Experts believe DSG could have to find hundreds of millions in unpaid tax and Astra Zeneca is known to have provisioned £890m to transfer pricing claims.

It's not a surprise the numbers are increasing; one would expect HMRC to focus on the large cases which could yield anywhere between £10m and £100m and, in some cases, much more. However, smaller entities are not immune and we would encourage any organisation which has a foreign parent or subsidiary company to review its transfer pricing policies. We can assist with transfer pricing reviews, our tax consultants having extensive experience of enquiries of this sort. Remember, forearmed is forewarned.



Trade credit insurance scheme starts up

Businesses that are facing cuts in the level of available credit insurance cover can begin to make use of a new government support scheme which came into effect on 1 May 2009.

As announced in the Budget, the government's trade credit insurance scheme is to provide up to £5 billion of additional insurance to businesses that have suffered reductions in their level of cover. Under the government scheme, which is to run from 1 May until 31 December this year, UK businesses will be able to purchase six months' 'top-up' insurance from the government if credit limits on their UK customers are reduced. The qualifying window will be backdated to include any reductions since 1 April 2009.

Businesses can buy the government-backed insurance to restore cover to the original level or double the amount they are able to obtain from the private sector up to the value of £1 million, whichever is the lower. The scheme was set up in response to worries among firms that cuts in the levels of insurance cover available from traditional sources has been pressurising suppliers into shortening their payment terms, putting extra strain on business cashflows.

Businesses that wish to apply for the scheme should contact their existing trade credit insurer, the Department of Business has advised.

Will MPs scupper the second home rule?

The MP's expenses scandal rumbles on, but the story took a new twist with revelations to the wider public concerning the use of the "second home" elections available under existing Capital Gains Tax (CGT) legislation.

The technique under which a taxpayer acquiring a second home can elect which is to be regarded as his main residence for tax purposes, and then having made an election, can vary that election at any time has long been regarded as ripe for change by a Labour Government, as it essentially allows the better off to accrue tax free gains on two properties at once by using the three year rule.

For the uninitiated, Tony owns a large manor house in his constituency which is the family home. On election as his local MP he initially rented a base in London, but was soon able to claim support under House of Commons rules which allowed him to purchase a nice flat near Westminster, and furnish it at taxpayer's expense. Within two years of acquiring the flat he nominates his constituency home as his principal private residence (PPR) for CGT purposes. Tony is keen to "trade up" when possible so after two years ten months of ownership he sells the flat and buys another one, making a profit of £60,000. So far, this is liable to CGT, but he can now elect that the flat is treated as his PPR, backdating the claim by two years. This will provide him with three years' exemption (in other words all of the gain) but at the loss of exemption on his constituency home. So he once again varies his election - within a week - again backdated for two years, and hey presto, both properties are exempt with only a week of taxable gain in the constituency home (which over many years of ownership will be tiny).

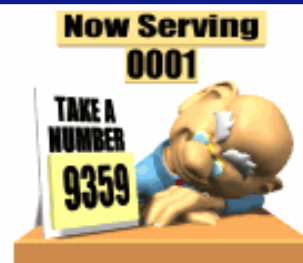
This rule is clearly most favourable to those who can afford two (or more) homes, and provides potentially significant tax free gains. We are proud to say that our advice in this area has allowed one client to achieve tax free gains in excess of £5 million. The three year rule is there so that those trying to move house (particularly those moving to follow work) are not disadvantaged when it is difficult to sell their home in a property market slump - the time period was increased from two to three years in the last housing market slump.

But how can this now be sustained in the light of the current revelations? Perversely, the cynics may consider that one reason for retaining the rule has been to benefit MP's with second homes, but now this very issue may bring the exemption to an end - with tax revenues sought wherever possible, and this Government regarding the better off as a suitable target, might we see an end to this concession? The man in the street - and indeed those who have had their homes repossessed - might justifiably ask why tax breaks are available to those with second homes. The CGT private residence exemption is estimated to have cost £14.5 billion in 2007/08 and £5.3 billion in 2008/09 (the decline is due to a combination of falling house prices and fewer people moving home); it is not possible to establish how much of this relates to second home exemption, but when short of money, any Government would probably find public support for removing a second home exemption - except maybe from their own members!



Pension tax relief - the transitional rules

New rules have come into effect restricting the amount of tax relief on pension contributions for "high income" individuals. The Chancellor announced in the Budget that those with incomes over £180,000 will only be entitled to relief at 20%, with relief being tapered down to this level for those earning above £150,000.



Under the new rules, someone with sufficient earnings to fund the maximum pension contribution of £255,000 per annum (applicable for the 2010/11 tax year), will see a reduction of £76,500 in the tax relief they would otherwise have received. As a double blow, income at the higher rate of 50% will be charged on pension benefits taken in retirement.

The restriction will apply from April 2011, but, to prevent additional pension contributions attracting the current 40% higher rate tax relief prior to then, there is a special tax charge for payments made after Budget day (22 April 2009) where the contributions exceed £20,000 per annum (the "special annual allowance") and where they represent a change from normal pension accruals or regular payments (made quarterly or more regularly). These transitional rules are important and complex.

In summary, full income tax relief on pension contributions will only be available for this tax year and next tax year where the individual continues to pay contributions at broadly the same rate as they have done previously. Where this is not the case, higher rate tax relief will be limited to contributions of £20,000. At this stage the legislation is in draft and further details may emerge as it passes through Parliament. However, there are several important points to note. For example, the restriction will apply where total income (minus certain reliefs) exceeds £150,000, not just, say, salary from the employment. Also, the provisions will apply if income exceeded £150,000 in either of the two previous tax years, even if it does not reach that level in the relevant year.

Those who continue with a pattern of regular (employer and employee) pension contributions will not be affected, as long as those contributions are made at least quarterly (such contributions will be known as "protected pension inputs"). Where the tax relief is to be restricted, the individual will be required to pay a charge, based on the excess between the top rate of tax and the basic rate, on the amount of contributions in excess of the special annual allowance of £20,000. This charge is to be collected through the self-assessment tax return.

The Government has committed to consulting on the proposals, which might lead to some changes before the legislation is finalised. In the meantime, anybody considering making payments into pension plans, altering employer and/or employee pension contributions or switching pension schemes should take advice before taking action. The Budget measures highlight the need to take care if tax relief is not to be unnecessarily lost or if unnecessary tax charges are to be suffered and also offers some planning opportunities.

Director disqualifications

Underpaid tax has been cited as the most common reason for the disqualification of company directors, according to recent research. Other factors include the failure to keep correct accounting records, theft and fraud, and continuing to trade whilst the company is insolvent. The research also revealed a 31% jump in company director disqualification proceedings launched over the past year. Disqualification proceedings were launched against the directors of 1079 companies in the year to 31 March 2009, up from 820 in the previous year.



Underpayments of tax to HMRC account for actions against the directors of 403 companies - or 37% of all cases launched in 2008-09, indicating that despite HMRC advocating greater leniency towards businesses facing cash flow problems, the Insolvency Service is becoming more aggressive.

Many directors choose to pay suppliers first as they consider them more important for the immediate survival of their businesses. However, they must not forget that failing to pay HMRC whilst continuing trading could eventually land them into trouble personally.

Profit from health and safety policies

It's tough enough to make a profit these days, without the ongoing costs of compliance. Your profit and loss account probably shows health and safety compliance as a cost rather than a saving. Why should any organisation invest their hard won profits in a lot of legal red tape?

Organisations usually see health and safety as a necessary evil and one that will cost them money to stay on the right side of the law. Most safety advisers take the view that health and safety is in fact good for the business and is there to protect people within the business, including staff, visitors, suppliers or customers.



Here are five ways you can benefit from health and safety so that they deliver real value to the bottom line.

An eye on quality processes - It's important to keep a check on efficiency and effectiveness in your business. Using an integrated management system that aligns the various legal requirements to reduce paperwork, cut down on bureaucracy and streamline the business processes will help. This means that the staff who previously had to spend their time inputting the same information in several different places will now be free to engage in more productive work. With many companies looking to cut costs in the current financial climate, this is great news, as it means fewer people are needed to deliver the same result. Creating a safer and more efficient business will impact on the bottom line and increase profits.

Taking action to reduce costs - you should understand some of the health and safety requirements affecting your business to ensure you don't become a victim. Even sole proprietors must have a health and safety policy (and know what it is), even if it's not written down. The minute the employee count gets to five, a written policy is essential.

If your business occupies a building, there will be issues regarding the facilities management of those premises. The planning, building control, licensing, and environmental authorities will all have their say. The architect will (for the most part) simply comply with their instructions. However, these agencies tend to have a 'one size fits all' approach and they're not always right. You may be issued with an enforcement or prohibition notice, but it's not uncommon for enforcement agencies to issue unenforceable notices. Complying with unnecessary notices can cost thousands of pounds, not least in fines if compliance isn't delivered properly. You should take action as soon as any notice is issued to you, no matter how long you appear to have to make changes. It's also a good idea to seek alternative opinions, as the 'one size fits all' approach can prove costly and there are often other ways to achieve the same end result at much less cost.

Go green - We recommend that you take a good look at the environmental issues that impact on your business. There are usually many things that can be done to make the organisation more environmentally friendly. A good environmental management system can make substantial savings in energy bills, consumable items and, in some instances, can even earn money back for the business. Training the staff to turn off lights, work stations and other appliances can make a significant saving. Recycling waste can also be a cost saving. Consumables can be cut by using low energy, long use products. Being environmentally aware can make a real impact on the balance sheet.

Upgrade standards for profit - With government bodies advising suppliers to focus on the public sector (in the face of a struggling private sector), organisations have to meet their minimum requirements in order to qualify. One of the biggest hoops that organisations have to jump through is meeting a rigorous health and safety checklist. These requirements are likely to be much more than the business would need ordinarily. For instance, the requirements for anyone bidding for contracts related to the 2012 Olympics are just about as tough as it gets. If all the boxes are ticked, the opportunities expand and your business will benefit from lucrative contracts that are still available from public sector. As an added benefit, it will make your business more attractive to private sector clients too. As belts are tightened even the private sector is much more conscious of the need to ensure that suppliers deliver good quality, reliable goods and services and so their demands are increasing.

Business improvement to create profit - Look at health and safety from a business improvement point of view. With the right approach, the savings can be substantial. By integrating business improvement processes into the health and safety systems you could find safety activities protect the people and also improve the rate at which they are able to operate, cut down waste, streamline processes and allow you to allocate people in a much more productive way. The impact on the bottom line can be as much as ten times the investment.

All this may seem like more red tape, but viewed from a more positive perspective it is just another aspect of business management. We and our clients know that if you focus on managing your business, the finances will flourish.

Index link your pension?

It may seem strange to talk about inflation at a time when the RPI is falling - and we may even face deflation soon - but the recent decision by the government to use "quantitative easing" (spending money it hasn't got without issuing corresponding gilts) raises the spectre that inflation could soon return with a vengeance. It is also reported that the inflation rate for pensioners is almost four times the official rate at 12.2% a year, compared with a headline figure of just 3.1%, largely because they tend to purchase services, rather than goods.



This is not just a characteristic of the current economic environment. Because pensioners are more likely to spend on things like food and heating, rather than electronics and other items that are more sensitive to market conditions, they almost always face a higher rate of inflation than the "average". This - and the fact that pensions, where they increase at all, tend to do so only in line with the RPI - makes it increasingly clear just how important it is for individuals to ensure that they are making adequate pension provision.

The sums are simple, if a pension increases at 5% a year and the real rate of inflation is 12%, then after 10 years, a pension starting at £25,000 a year will have fallen behind by more than 40%. After 25 years, the shortfall is almost 80%.

Something of a slip up

Emma Hope, a British shoe designer who has designed shoes for Paul Smith, Anna Sui and Mulberry, as well as for the actress Uma Thurman and for the film *Pride and Prejudice*, has seen one of her companies enter administration.



Interestingly, her footwear is also worn by film star Keira Knightly and Chelsea player Frank Lampard - though not in *Bend it Like Beckham* or at Stamford Bridge.

Her related retail outlets are still trading.

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Newsletter Content

This newsletter deals with a number of topics which, it is hoped, will be of general interest to clients. However, in the space available it is impossible to mention all the points which may be relevant in individual cases, so please contact us for personal advice on your own affairs.

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straightforward

Like you, we're straightforward people. We give you straight advice, you take your business forward. No nonsense. Straightforward isn't it?