Bernard Harrington and Company
Business Intelligence
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Goodwill and Incorporation

Introduction

In recent years many sole traders have transferred their businesses to newly incorporated companies in which they have a controlling interest. In many cases the transfer will involve the company buying the goodwill of the business and there are normally good reasons for making that value as high as possible. This article explains when the Inland Revenue might challenge the value attributed to transferred goodwill and the tax consequences where it is established that the payment for goodwill exceeds its market value.

For simplicity this article focuses on transfers by sole traders. Similar considerations apply to the transfer of goodwill from individuals who carried on business in partnership.

Inside this issue:

Goodwill and Incorporation	*1,2,3*
Planning for a comfortable retirement	*3*
Main residence elections	*3*
Selling a business? Keep it quiet!	*4*
Childcare vouchers - another fine mess	*5*
A better start in life?	*6*
Civil Partnership Act	*6*
Business groups raise concerns over working hours	*7*
A monster is born?	*7*
UK seeks to soften VAT blow	*7*
A lesson in life	*7*

When might the value of goodwill be challenged?

The Revenue are most likely to challenge cases in which where they think that a transfer of goodwill may have taken place at overvalue.

Their concern is that any overvaluation of goodwill could allow the excess value to be wholly or partly sheltered from tax because various Capital Gains Tax (CGT) reliefs. These usually have the effect of reducing the tax on such transfers to no more than 10% while simultaneously inflating a loan account balance against which a participator could withdraw sums without attracting any tax liability. There may also be concerns when the goodwill acquired by the company falls within the “Intangibles Regime” or if it seems that the type of goodwill reportedly sold to the company was associated with the personal skills and attributes of the sole trader, so that it was not capable of actually being transferred. The Inland Revenue offers a service under which CGT valuations can be referred to a specialist tax office for checking after the transaction has taken place but before the relevant tax return is submitted. Such checks are usually in your interest.

Capital Gains

For the purposes of CGT where an individual disposes of goodwill to a company in which he (or he and persons connected with him) have a controlling interest the transfer is treated as having taken place other than at arm’s length. This means that for CGT the disposal by the individual and the acquisition by the company are deemed to have taken place at market value.

Excess value may be employment income

Where the goodwill is deliberately overvalued when it is sold to the company (arguably as an inducement for the individual to take up employment with the company, or in return for future services to be provided by the individual to the company) the excess payment may be taxable on the vendor as earnings. Where, exceptionally, excess value is paid in respect of the transferor’s employment but it cannot be characterised as ‘earnings’ the overvalue may be chargeable as a benefit in kind. In such cases the reporting obligation on the employer will depend on whether the excess value is regarded as earnings or a benefit. Earnings should be subjected to PAYE. A benefit should be reported on form P11D.

The excess value is also liable for Class 1 National Insurance Contributions (NICs), because it derives from the employment and is therefore a payment of “earnings”. This treatment applies irrespective of how the payment has been characterised for income tax purposes. There is no provision for “making good” for NICs, so even if the tax charge on the benefit is reduced by making good, Class 1 NICs must be accounted for on the original excess value.

The charges would be considered to have arisen on the day the goodwill transaction took place.

Where the excess value is treated as employment income it may give rise to a tax deduction for the cost borne by the company.

Excess value may be a distribution for tax purposes

In many cases the goodwill will have been transferred from a sole trader to the company before the company has commenced trading. In such cases, the transferor must have received any overvalue in his capacity as shareholder, rather than as an employee/director. As a result, the excess value will, for tax purposes, be treated as a “distribution”, akin to a dividend. For NICs purposes, where the transferor receives any overvalue in his capacity as shareholder, rather than as an employee/director, that is derived from a shareholding and not employment. The overvalue cannot therefore be classed as earnings and does not attract NICs.

Distribution: impact on individual

Where it is established that the excess value is a distribution the individual will be treated as having received income equal to the amount of the excess value plus the associated tax credit. If the individual is liable to income tax only at the lower and basic rates this tax credit will be sufficient to cover the basic rate tax charge. If he pays income tax at the higher rate the tax credit will not cover all of the tax liability. This will usually be the case and the higher rate tax can be as much as 25% of the distribution.

Distribution: impact on company

Where the goodwill was transferred before 1 April 2004, the characterisation of excess value as a distribution will not affect the company’s tax position. For transfers on or after 1 April 2004 the distribution will have to be taken into account in computing corporation tax liability at the non-corporate distribution rate, but this is only of relevance to companies reporting profits of under £50,000 in a year.

‘Inadvertent’ distributions may be unwound

Because of the uncertainties in establishing the value of goodwill there will clearly be occasions where a transfer is inadvertently caught. If it is clear that there was no intention to transfer the goodwill at excess value, and reasonable efforts were made to carry out the transaction at market value by using a professional valuation, then the distribution may be ‘unwound’.

The distribution may not be unwound if there is attempted (or actual) avoidance, or if the overvaluation was intentional, or if no professional valuation was obtained. The Revenue normally regard ‘professional valuation’ as including one carried out by a named independent and suitably qualified valuer on an appropriate basis. But in some instances it may be necessary to establish what steps were taken to arrive at the value, what instructions/information were given to the valuer, whether it was reasonable for the parties to rely on the valuation provided etc. before an application for unwinding can be accepted.

Where it is agreed that an inadvertent distribution may be unwound the individual must repay the excess value to the company. Where the original sale proceeds were credited to a loan account, that credit should be reduced, effective from the date of the original transaction. If the individual has drawn from the loan account on the strength of the original credit, rewriting the loan account to reflect the unwinding of the distribution may result in the loan account becoming overdrawn. If so, the company may be liable to tax under the “loans to participators” rules.

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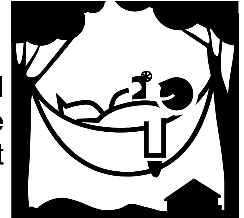
Intangibles Regime

From 1 April 2002 the new Intangibles Regime allows companies to claim an income deduction for tax purposes based on the goodwill amortisation shown in their accounts. Where the goodwill was acquired from a related party (such as a sole trader who controls the company) the Intangibles Regime will only apply if the goodwill was created wholly after 31 March 2002.

Where goodwill has been acquired from a sole trader and income deductions are made under the Intangibles Regime, the Revenue will be concerned to confirm both that the goodwill was created wholly after 31 March 2002 and that for tax purposes the value of goodwill equates to its market value.

Planning for a comfortable retirement



A number of recent surveys have highlighted the inadequacy of retirement provision and saving by most people. Even if it is not currently top of your agenda, being able to retire when and how you want is sooner or later likely to be one of your most important financial objectives. However, achieving this goal takes careful planning.

Fewer and fewer people enjoy the luxury of a fully funded final salary pension scheme and, for many self-employed people, insufficient provision for life after work means that they are forced to continue working longer than they would wish or face a dramatic decline in their standard of living.

You could spend a third of your life in retirement. Will you find those years the golden times we all dream of, or a constant struggle to pay the bills?

We can help you to plan for a financially secure retirement. April 2006 heralds a major overhaul of the pensions regime - there are some excellent tax and financial planning opportunities available in the months running up to this change and once the new system is in force there will be further scope for long-term tax mitigation. For more information, visit the retirement planning guide as our website www.bhonline.co.uk

Main residence elections

An election for a second home to be treated as the main residence can sometimes offer substantial tax savings. But it's worth remembering that you need to keep an eye on these things - it's definitely not a case of "file and forget".

For example, an election lasts only as long as the number and identity of your homes remains unaltered. So an election made to treat your country home as your main residence will lapse when you replace (or indeed supplement) the London flat with a villa in Portugal. Possibly that's not a problem - it depends on the facts - but don't let it happen by default. The only safe rule is to revisit any election every time you gain or lose a residence. In fact, our advice is that whenever you come to own two residences, a main residence election should routinely be filed - even if you consider the election pointless because it is quite clear that the property on which you're electing is in fact the main residence. Why? Because by electing you are holding open the opportunity to vary the election if it should ever be advantageous to do so in the future. And one particular circumstance in which you might want to do just that is for favourable tax planning on sale of the second home. For example, you may want to switch the election to the second home, only to switch it back again as a little as a week or so later. This will unlock the door to exemption for the last three years' ownership (and to any available "residential letting" enhancement) at a cost of sacrificing only a week's worth of exemption on the actual main residence.

The election to choose which is your main residence for CGT purposes has to be made within two years of the period to which the election is to apply. Often this means within two years of the acquisition of the second property. If you leave it too late to make the election, it can sometimes be a good idea deliberately to do something which triggers a fresh opportunity to make the election. For example, if one of your properties is rented out, the departure of a tenant could provide such an opportunity. Once an election has been made, it can be varied at any time. Again the variation will be effective from a date no earlier than two years before the notice of variation. It is often overlooked that the election can only apply to a property in which you actually reside. It cannot apply to a property that you own, as a buy-to-let investment perhaps, but never occupy.

Selling a business? Keep it quiet!

Business owners wanting to initiate the sales of their business usually turn to a professional for advice at some step of the way. Exit planning in itself is a complex process and should have begun well before the business goes on the market, although experience shows this isn't always the case.

The vendor's aim is naturally to obtain the maximum price for the business when it is sold, and often this can only be achieved by a careful restructuring of the organization before the sale actually commences.

The valuation itself is affected by many factors. Prevailing conditions in the marketplace must be identified, understood and related to the enterprise being sold. The valuer won't rely exclusively on the vendor but will research his own sources of information in reaching a view.

Then there are all the other requirements – the contract of sale, valuations of individual assets and the possible employment law consequences. It's not something that can be handled quickly, nor is it a simple task to complete correctly.

Once the decision has been taken to sell a business, it's not always a good idea to tell the world immediately. There are many issues that require careful consideration so that the value of the business remains unaffected while the sale process is completed.

Where a business is known to be for sale, it can raise concerns in the minds of several important groups of people. Staff members wonder about the security of their jobs and may well start looking around for new positions. Suppliers become concerned about getting paid for their latest invoices and can tighten credit terms, and competitors reach for their phones to contact every customer of the business they know about to offer them an 'unbeatable deal' if they'll change their source of supply. It's important to keep things under wraps until the appropriate time - and indeed this avoids the embarrassment which inevitably results from an abortive sale.

An experienced professional adviser will begin by preparing an accurate summary of the key points about the business so that it conveys the most of the information a prospective purchaser would like to know without giving away enough to make a positive identification. This information can be used by business agents or brokers that become involved in the marketing process.

Any prospective buyer should be asked to sign a confidentiality agreement before any further details of the business are revealed. The list of prospective buyers should be carefully checked so that direct competitors can be identified and won't benefit from some critical market knowledge.

The underlying aim of all this secrecy is to retain the value of the business as a going concern, and that includes both people and its position in the market. If word gets out too early that the business is for sale, its value can be materially affected and significantly reduced from the price it would otherwise have achieved.

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Childcare vouchers - another fine mess

Employees should do their sums carefully before accepting childcare vouchers in lieu of a salary increase - those receiving working tax credit should be particularly careful. Neither the guidance available on the Inland Revenue website or from some employers is particularly helpful, as the decision will depend on the individual's circumstances.

Employer-provided childcare vouchers which are free of tax and National Insurance up to £50 per week were introduced from 6 April. Employers are being encouraged to provide them for their staff, but many lower or middle income people will be worse off if they take vouchers instead of a cash alternative; the sting in the tail is that there is an effect on their working tax credit entitlement (WTC).

Some employers and sellers of childcare vouchers play down any risks to the tax credit and a significant minority of people may, through ignorance, have a nasty surprise awaiting if they haven't done the arithmetic. The Inland Revenue have done little so far to explain the complexities either, their guidance concentrating on the tax and NIC savings but without worked examples showing how these interact with WTC entitlement.

Families that are at the lower end of the income scale are entitled to WTC and help with up to 70% of their childcare costs, subject to certain ceilings. Having your employer pay the childcare with a voucher can mean you lose some of your WTC at a rate of 70p in the £. Worse still, families on higher rates of tax credit can lose more in tax credit than they gain in tax and NIC exemption by accepting vouchers. Those most likely to benefit from the childcare vouchers scheme are the very highest earners as they are not entitled to fast taper credits, their tax and NIC savings are the greatest and they are likely to be paying for more expensive childcare. Lower or middle income earners trying to choose between accepting childcare vouchers in return for a salary sacrifice or claiming tax credits help towards childcare costs need to be careful. Broadly, they will benefit from taking a tax and NICs-free voucher if it is offered to them on top of their salary with no cash alternative.

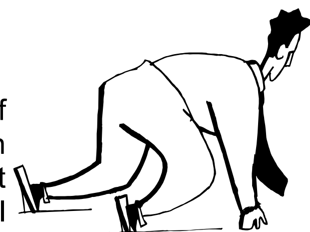
In addition, to come to the right decision, some or all of the factors below will have to be taken into account:

- whether the vouchers are to be used to replace childcare costs which are not attracting tax credits relief at 70%;
- whether increases in salary are under or over the £2,500 disregard, if the vouchers are used in a flexible benefits scheme where employees can choose cash or benefits (and for those with partners we need to look at the joint position);
- the rates of tax payable by the individual;
- the rates of national insurance payable by the individual;
- whether the individuals income (and for those with partners we need to look at their joint position) is high enough to have fully tapered away tax credits at the 37% rate;
- the impact of the national minimum wage;
- the potential loss of employer's and state benefits arising from choosing vouchers rather than cash, and
- the introduction of vouchers part way through the tax year, or changes in circumstances during the tax year (for example, the loss of or acquisition of a partner, or loss of employment by a partner) will affect the sums.

If the vouchers are to run into 2006/07 the calculation will change again when the childcare tax credit loss will rise to 80p in the £. For the well-intentioned employer, our advice is that they should warn participating employees to notify the tax credit office of their reduced childcare costs (mandatory notification attracting a penalty for failure). Secondly, employees should be told to seek advice about their tax credits before accepting the scheme; as we have seen, there are many ways in which this scheme will impact different families for tax credits depending on their circumstances and the rate of salary sacrifice. The other aspect which represents a potential danger area for employers is the National Minimum Wage. For lower paid staff, the salary sacrifice required to get he childcare vouchers may take them below minimum wage, at which point the employer is then liable for the shortfall! Because of the requirement to offer the scheme to all staff, this can cause severe problems.

In summary, as with a lot of our last Chancellor’s ideas, it sounds better on paper (or in a soundbite) than it actually is! Great care is needed!

A better start in life?



One of the biggest financial problems facing young people today is the amount of debt they will have incurred by the time they leave university. The average British graduate leaves university owing £13,501 - an increase of over 10% in the past year, according to a recent study. In total, British students graduating this year will have debts of more than £2.46bn, the rise being due in no small part to rising living costs and a more resigned attitude towards debt. If this trend continues, students starting a three-year course this September could be graduating with debts of almost £20,000. One encouraging aspect, however, is the news that the number of students with debts has fallen from 80% to just under 75% during the past year, possibly a result of more students taking a year off before university, to earn money.

Parents of children destined to go to university should consider the following strategies for reducing the debt burden:

- For younger children, the new Child Trust Fund may provide the opportunity for parents, grandparents and other family members to help offset university expenses. With the payment of £250 from the Government, plus a proposal for a second and perhaps further state payments, parents and others can add up to £1,200 a year to the tax-free fund.
- Older children will not receive the Government help, but they do have their own personal allowances, meaning that income of up to £4,895 escapes tax this year.
- Trusts (and gifts from senior family members) can be an effective method of funding school and university costs and can be used to purchase property occupied by students.

Further information on these and other tax and financial strategies for you and your family is available from our award winning website www.bhonline.co.uk

Civil Partnership Act

The Civil Partnership Act 2004 was enacted last November. The provisions which enable the registration of civil partnerships are to be brought into force on 5 December 2005. As we expected, the Inland Revenue have confirmed that they will make changes to all existing tax legislation, so that registered civil partners will be treated the same as married couples for tax purposes. The new rules will apply from 5 December 2005. Notable changes include the inter-spouse exemptions for Inheritance Tax, Capital Gains Tax and Stamp Duty Land Tax. At the same time, civil partners will be brought within all the anti-avoidance provisions that affect spouses. There will also be changes to the pensions legislation, including the new rules coming into effect on 6 April 2006.

These changes will not affect all same-sex couples, only those who register a civil partnership. Therefore, although the Government's publicity has said that many same-sex couples will be eager to make a formal legal commitment and could now do so before Christmas 2005, such couples would do well to make sure they have considered all the tax consequences before going ahead.

There is one change will affect married couples as well as civil partners. From 5 December, the married couple's allowance for those born before 6 April 1935 will be based on the income of whichever partner has the higher income. Currently it is based on the husband's income. This will apply to civil partners and to new marriages on or after that date.

We still await details of when the tax credit changes required under the CPA will be introduced. These will apply to all same-sex couples who live together, not just those who register.

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Business groups raise concerns over working hours

The Institute of Directors (IoD) has urged the government to fight to support the continuation of the UK's right to opt out of the EU Working Time Directive. According to the IoD, 40% of UK firms currently make use of the provision, which means that employees can choose to work longer than the average maximum 48-hour week imposed by the directive. Opponents of the opt-out argue that the country's 'long hours culture' means that some members of society, such as women who have children, find that their career development is placed at a disadvantage. However, the IoD warns that removing the option would cause significant damage to British business, particularly in such sectors as construction, mining and transport, as well as tourism and financial services.

A monster is born?

HM Revenue & Customs (HMRC), the new department responsible for the business of the former Inland Revenue and HM Customs and Excise, has launched its new website. Chancellor Gordon Brown confirmed the Government's plans to integrate the two organisations in his 2004 Budget. Business groups are hoping - unduly optimistically we fear - that the creation of a new single department will help to simplify the tax system for small businesses. An independent prosecutions office, the Revenue and Customs Prosecutions Office (RCPO), has also been launched, and will prosecute HMRC's criminal cases.

UK seeks to soften VAT blow

The government has pledged to minimise the impact on business of a European Court of Justice decision that overturns the UK's rules on the VAT treatment of travel expenses.

Under UK tax rules, businesses can reclaim VAT on road fuel bought by employees for work purposes, when the employee is reimbursed by their employer for the cost of the fuel. But the ECJ found that this was 'not compatible' with the EC directives, which state that to exercise this right, the employee would need an invoice for the petrol. The decision basically means that any purchase the employee makes, which the employer then reimburses, including hotel and food bills, will now no longer be subject to a VAT reclaim. However, Customs have said that businesses should stick with the current UK rules for the time being, while the government considers its position. Watch this space!

A lesson in life

A crow was sitting on a tree, doing nothing all day. A rabbit asked him, “Can I also sit like you and do nothing all day long?” The crow answered: “Sure, why not.” So, the rabbit sat on the ground below the crow, and rested. A fox jumped on the rabbit and ate it.

Moral of the story: To be sitting and doing nothing, you must be sitting very high up.

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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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