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SUMMER 2015

HMRC Enquiries: Breaking Records!

If you run a business, the law requires you to keep full records of your income and expenditure. In the case of limited companies, there is specific legislation concerning the nature of the records to be kept, but all businesses must keep sufficient records to enable them to prepare accurate accounts and tax computations.

There are penalties for failure to comply with these rules, but a recent case (Mirsamadi v HMRC [2015] UKFTT 58 (TC)) highlights the other consequences of poor record keeping, which are often more serious than mere fines imposed by the legislation.

The case centred on Mr Mirsamadi's 2007/08 self-assessment return. This showed a small amount of property income, but apparently HMRC had information about other business activities, including other property lettings and the operation of food takeaways.

Mr Mirsamadi had not kept proper records of his business activities – he admitted this – and so HMRC embarked on an exercise to calculate the likely level of undeclared income.

HMRC's methods

There are two main ways in which HMRC will do this. They can take the 'business economics' approach, whereby industry norms of profit ratios are applied to the known facts. A typical example in a retail business is to look at stock purchased and to apply a mark-up derived from the taxpayer's own price lists, or from typical profit margins for the sector concerned. This is particularly effective when takings have been suppressed but the purchases have been correctly recorded. Some of the ratios used can be rather exotic – a colleague of mine when I was a tax inspector claimed to have increased the taxable profits of a greengrocer based upon the number of brown paper bags he had purchased, which were far more than was needed to fill with the quantity of fruit and vegetables he claimed to have sold!

In Mr Mirsamadi's case (possibly because the records were so poor that a business economic approach could not be used), HMRC adopted the other approach, based on looking at the taxpayer's personal expenditure.

The details of this are usually complex, but the proposition is simple: work out the increase in the taxpayer's assets over a period, and his expenditure on everyday living during the same period. If there is a lack of sufficient declared drawings from the business to cover these costs, the assumption is made that the shortfall represents undeclared income.

Unrecorded takings?

Tax inspectors look at business records with a view to 'breaking' them – that is, demonstrating that the records cannot be correct either because they are internally contradictory or because large estimates have been needed in order to balance the books. For example, if there is more money in the business bank account than can be accounted for using the known sales, the taxpayer may have assumed he must have introduced cash into the business. Unless he can prove this, HMRC will take the view that the extra money in the bank is unrecorded takings.

'Breaking the records' is fundamental to the more serious type of tax enquiry. Once HMRC have demonstrated that the records cannot be relied on to provide an accurate figure for business profits, HMRC can substitute their own figures, based either on 'business economics' or the 'means test' approach used in the case of Mr Mirsamadi. Provided their methods and results are 'reasonable' the tribunal is likely to uphold their findings, as it did in the case of Mr Mirsamadi.

Practical Tip:

It makes sense to keep proper records in any event, in order to know how your business is doing; but if you fail to do so, and are subjected to a tax enquiry, you may be handing a blank cheque to the taxman.

IN THIS ISSUE

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Developing A Property – Trading Or Investing?

If you buy a property and spend money on improvements or even on a complete rebuild, you are likely to be doing so for one of two reasons – either you hope to sell the refurbished property at a profit, or you intend to keep it and derive an income from letting it out.

Why does it matter?

The distinction is important because in the case of a sole trader or partnership, a profit on the sale of the property will be charged to income tax (at up to 45%) in the case of a property development trade, whereas in the case of a property investor, the sale will attract capital gains tax (at 28%).

In the case of a limited company, both income profits and chargeable gains are charged to corporation tax at 20%, but there are still important differences in the accounting and tax treatment.

Property developers (who buy and refurbish with a view to sale) are also required to operate the construction industry scheme on payments made to subcontractors, and penalties for failing to do so can be severe, whereas landlords of investment properties are generally not liable for this unless their expenditure on construction operations is very high.

From time to time, HMRC will look closely at a property disposal that has been treated as the sale of an investment and that produces a capital gain, to see if it was in fact a trading transaction.

Intention is important

In theory, it is the intention at the time the property is purchased that will determine the correct tax treatment, but in the real world things are often more complicated.

A recent case (Terrace Hill (Berkeley) Ltd v HMRC [2015] UKFTT 75 (TC)) involved a limited company that acquired and refurbished a property, and then sold it shortly after all the offices had been let to tenants.

This is a typical property developer's strategy – the value of a commercial property can be significantly increased by getting good quality tenants established – but the company claimed it had intended to keep the property as an investment and had only sold it when the rental profits proved disappointing and they received a good offer for the property.

The distinction was important in this case because the company had bought a tax avoidance scheme from one of the 'Big Four' accountants (KPMG), but the scheme only avoided tax on capital gains, not on trading profits. Not surprisingly, HMRC were keen to prove the profit on the building was a trading profit (having previously reluctantly accepted that the avoidance scheme did indeed avoid tax on capital gains).

The details of the case are not important, but the significant point is that the First-tier Tribunal accepted the evidence of various directors of the company, all of whom explained that the original intention was to create an investment to produce future income, and that the sale only happened because of disappointing results and a good offer to buy. The tribunal emphasised that they were impressed by the directors' integrity as well as their knowledge of the property business.

Practical Tip:

This case illustrates an important principle about the distinction between trading and investing – it is the intention that is the fundamental way to determine what sort of transaction is involved, not the bare facts such as the time between purchase and sale. If you can show you bought the property intending to hold it for its income, the fact that you sold it as a result of getting a good offer shortly afterwards need not convert the transaction into one of trade.

Don't Lose Your Losses!

The recent First-tier Tribunal case of Amah v Revenue & Customs [2014] UKFTT 1084 (TC) highlights a problem when a loss making trade changes in a significant way. The same problem can arise when a trading company changes ownership. Losses can only be carried forward against future profits of the same trade, so it is important to be aware of what is regarded as a change in the nature of a trade.

Mr Amah is an optician. Until 2009 he ran his own optician's business, as a franchisee of Dolland & Aitchison. He closed his shop in 2009 and began working as a locum in other opticians' practices.

HMRC said he could not carry forward losses from his days as a franchisee against his income as a locum, and the tribunal backed them up. HMRC put forward various arguments, all of which the tribunal accepted:

- running an optician's practice is a trade, whereas working as a locum is a professional activity. This is a rare example of the distinction implied in the tax legislation's description of income tax on 'the profits of any trade, profession or vocation' being of real significance; and
- the change in activity involved a change of customer – as an optician, Mr Amah's customers were the general public who he supplied with glasses and other optical aids; as a locum, his customers were the opticians who he worked for.

The same trade?

If you make losses in a trade (or a profession or vocation), then for income tax purposes you can carry those losses forward against future profits you make in the same trade. This applies only for as long as you carry on the same trade, and Mr Amah's case shows how important it is to be aware of what is regarded as a change in a trade.

The distinction between a trade and a profession is quite an unusual problem, but the change of customers is much more common as a reason for a trade to be treated as having changed. This need not mean simply a geographic change - it refers to a change in the type of customer. A common example is a change from wholesaling to retailing.

Another common example of a change in a trade is a different supply process. A good example is the case of a brewery (Gordon & Blair Ltd v CIR, CS 1962, 40 TC 358), which stopped brewing its own beer and instead bought it in bulk and sold it on. This was held to be a change in the trade sufficient to prevent losses being brought forward from the old brewing days.

In the case of an individual, when he ceases to trade there is no future income from his trade to set brought forward losses against, but in a limited company it is possible for the shares in the company to change ownership but the trade to continue.

The anti-avoidance rules for losses when a company changes ownership are complex, but one aspect involves a 'major change in the nature or conduct of' the trade concerned. If this takes place within three years either side of the change of ownership, any losses brought forward are disallowed.

The legislation goes on to define a major change as including: ‘a major change in the type of property dealt in, or services or facilities provided in, the trade, or a major change in customers, outlets or markets of the trade’.

Practical Tip:

A change in the nature of your trading activity can mean you lose your losses – if this is likely to happen, take professional advice to see if it is possible to use them up, for example by carrying them back to the three previous tax years, or by engineering a balancing charge through capital allowances.

Personal Tax

Payments On Account

If your total net tax liability for the year is less than £1,000, or if at least 80% of the total tax due for the year is covered by tax deducted at source, then you do not need to make payments on account for the following tax year.

The second test is sometimes missed by HMRC and people are asked to make payments on account unnecessarily, resulting in a loss of the use of the money unnecessarily early.

Case Study:

Robert calculates his tax liability at £7,000 for the year 2013/14, of which £1,200 relates to investment income payable under self-assessment. The remainder (£5,800) was deducted under PAYE.

Because his net tax liability is over the £1,000 limit, he assumes he has to make payments on account for the following year and hence enters these figures onto his Tax Return.

However, as over 80% of his total tax liability is deducted at source under PAYE, he meets the second test and does not need to make payments on account. The tax on his investment income is payable in full by 31 January following the end of the tax year. By being aware of this test, he avoids making payments on account and benefits from the associated cash-flow advantage.

Property Tax

Transfer of Assets on Separation

The CGT rules on gifts between spouses/civil partners as being at 'no gain/no loss' apply until the end of the tax year of separation. Ideally therefore, the transfer of any jointly held assets should be made some time before the end of the tax year in which separation took place in order to be fully exempt. The asset (which could include the main PPR) will gain an 'uplift' in value, which may be beneficial should the property be subsequently sold but without the advantage of the full PPR relief.

Should the transfer take place after the end of the tax year in which separation occurs, but before the granting of the Decree Absolute, then the parties are treated as 'connected parties'; as such, the disposal is automatically treated as being at market value whatever the actual amount paid.

Where a main residence and another property are owned jointly, there will be tax advantages should the leaving spouse leave the former matrimonial home on separation and go to live in the second property. Appropriate transfers of both properties in the tax year of separation, together with an election by each that the property they are occupying is their main residence, should ensure that gains on both properties are exempt.

Case Study:

Adam and Eve separate in May 2014. They jointly own a Buy To Let property. Adam transfers the property to Eve in January 2015.
The property originally cost £200,000 with costs of acquisition being £2,500. Legal costs on transfer were £2,500.

Adam's deemed disposal proceeds are:

Cost (50% share)	£100,000
Acquisition costs (50% share)	£1,250
Legal costs	£2,500
Total deemed proceeds	£103,750

Eve's revised base cost will therefore be her share **(£101,250)** **plus £103,750 = £205,000**.

Business Tax

Pay A Small Salary To Preserve State Pension Entitlement

Entitlement to the state pension and contributory benefits is contingent on having paid sufficient National Insurance contributions. Fortunately it is possible to achieve this for zero cost.

Persons with earnings between the lower earnings limit (£111 per week for 2014/15) and the primary earnings threshold (£153 per week for 2014/15) are treated as paying NICs at a zero rate. These notional contributions preserve entitlement to the state pension and contributory benefits.

For 2014/15 the secondary threshold is set at £153 per week. This is the same level as the primary threshold.

For 2014/15 the salary should be set at between £111 per week and £153 per week in order to preserve state pension entitlement for zero NIC cost. This equates to an annual salary of between £5,772 and £7,956. As this is below the personal allowance, providing the person does not have a second job to which the personal allowance has been allocated, no PAYE tax should be due either.

For 2014/15 onwards, employers are entitled to an allowance to set against their employer's Class 1 liability. The allowance is set at £2,000 for 2014/15. See Tip 66 for the impact of this allowance on the optimal level of salary.

Under real time information (RTI), details of the amount paid to the employee must be reported to HMRC electronically. HMRC's free Basic PAYE Tools software package can be used for this purpose.

Case Study:

Ian and Caroline are directors of their family company. To preserve entitlement to the state pension and contributory benefits they decide to pay themselves a salary of £7,200 (£600 per month).
As this is between the lower earnings limit (£111 per week for 2014/15) and the secondary earnings threshold (£153 per week for 2014/15) they get the benefit of notional contributions but do not have to pay any actual employee or employer contributions.

However, under RTI they need to make a submission to HMRC each time that they make a payment. They can use HMRC's free software package, Basic PAYE Tools, for this purpose.

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