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Crowdfunding – Tax Traps?

In the last few years, there has been a massive increase in the use of crowdfunding to raise capital for small business enterprises.

How does it work?

'Crowdfunding' works on the principle of finding large numbers of small investors, in contrast to the traditional method of finding a small number of large investors or a bank loan. Typically, it is an online phenomenon, with specialised websites offering exposure in exchange for a fee.

In many cases, the investors are in the position of lenders, and receive interest and have a timetable for repayment, or they become owners of some of the equity in the business, usually in the form of shares and quite often, these shares will themselves qualify for tax relief under the enterprise investment scheme or its more generous little sister, the seed enterprise investment scheme.

At the smaller end of the scale, however, the investors get nothing in return beyond the satisfaction of contributing to something they approve of and want to feel a part of.

In some cases there is a further reward, such as a mention on the recipient's website, or in its literature, or (in the case of a struggling pop group) on the DVD or album cover.

None of this need cause a problem – the rules for debt and equity are well known, and the tax implications for creditors and shareholders are clear.

The same applies to what might be called 'personal' crowdfunding where the money is being raised for personal reasons – to fund treatment for a sick child, for example, or to raise donations to a registered charity.

Taxable transactions?

Some crowdfunding offers, however, give something in return for the money donated to them. It may be tickets to a concert or a play, or a sample of the goods produced by the fundraising entity.

This may be another example of tax law not fitting well with modern society. There was a time when it was widely (and wrongly) believed that buying and selling over the internet was a sort of hobby, and not a taxable trading activity. Obviously, the giants such as Amazon were taxable (at least to some extent!) but Mr Jones in his front room with his laptop somehow thought he was not really in business. It was, I think, the novelty of the medium that confused people – if Mr Jones had rented a shop for his buying and selling, he would have thought of himself as a dealer in goods, and taxable on his profits.

If a business raises money through crowdfunding, and in return gives its funders goods or services in return, it is difficult to see how this could fail to make the 'donation' taxable income for both direct (income or corporation) tax and indirect (VAT) tax.

People are confused because the motive for the donation may not be to acquire whatever is offered in return, and as a 'donation' it is entirely voluntary. Unfortunately, there is good case law to support the proposition that if a trader receives a voluntary donation towards its business expenses, the donation is a taxable receipt of the trade.

Where the donation leads to a 'gift' of goods or services, the position is even clearer. A trader has received money, and in accordance with the terms offered on the crowdfunding website, the trader gives the payer its services or some of its trading stock. In what way is that not a trading transaction?

Practical Tip:

If you decide to raise money for a business through crowdfunding, make quite sure you are aware of the tax implications, and avoid an unexpected bill for income tax, corporation tax, or VAT.

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Landlords - Which Hat Are You Wearing?

If you own property in the UK and receive rent as a result, you are running a UK property business. Tax law says that all such UK lettings are to be considered as one business, so a loss on one letting property can be set against a profit on another. Effectively, all the rental income and all the landlord's expenses are stirred up together in the same pot to produce one profit or one loss for tax purposes.

It is important, however, to be aware of the limits of this concept. Some specific types of letting are separate businesses with different rules, such as lettings under the rules for furnished holiday accommodation, and any lettings of property outside the UK are obviously not part of a 'UK property business'.

There can be problems, however, where a landlord receives rent in more than one capacity.

Trusts and trustees

Property income received by a trust is normally taxed as the income of the trust, but in a case where the person who set up the trust (the 'settlor') is able to benefit from it (or his spouse or children under 18 can), the trust's income is treated as that of the settlor for tax purposes. This does not, however, allow the settlor to set a loss on trust property income against a profit on personally owned property, or vice versa. They are two separate property businesses.

There is one rather technical exception to this rule – if the settlor is also the 'life tenant' of the trust (meaning he has a legal entitlement to the trust income) and he runs the trust's rental business himself (doing this involves some rather complicated aspects of trust law), then that is part of his own UK property business and is included with any other UK property income he may have.

Partnerships and joint owners

Generally speaking, HMRC will resist the idea that a rental property owned by more than one individual means that the letting is done by a partnership. They will argue that a partnership involves 'carrying on a business in common with a view to profit' (Partnership Act 1890, s 1). They then argue (as they do for other taxes as well) that the word 'business' in the Taxes Acts' frequent references to a 'property business' somehow has a different meaning to 'business' in the Partnership Act.

In some cases – where the partnership has a number of properties and is clearly run in a business-like way, or more often where the partnership carries on some other trade and happens to have some letting income as well, HMRC will accept that the property is being let by a partnership.

This is important because it also means that any profits or losses from the letting allocated to an individual partner cannot be lumped in with any other property income he may have in his own right, because the partnership's UK property business is a different business to the individual partner's UK property business.

Where property is jointly owned and there is no partnership, however, the owners may allocate the profits or losses as they choose among themselves (subject to special rules for married couples or civil partners).

Unlike partnership property income, your share of the profits or losses from a jointly owned property are part of your 'UK property business' and included with any profits or losses from property in the UK that you own as the sole owner.

Practical Tip:

When calculating the taxable profits and losses of your property business, make sure you remember which hat (partner, trustee, joint owner, or sole owner) you are wearing!

Waivers Or Alphabets?
Dividends From Family Companies

Sometimes the shareholders of a family company want to pay dividends that are not in proportion to the size of their shareholdings.

Under company law, dividends paid on shares must be the same for every share of the same class – indeed, dividends are commonly expressed as being '£x per share'. For example, if I have 60 of the company's 100 £1 ordinary shares, and you have the other 40, and the company pays a dividend of £1,000, that is £10 per share and I will get £600 while you get £400.

In the case of a family company, this may not be what the shareholders want to achieve. For example, one may be paying income tax at 40%, while his spouse is a basic rate taxpayer. After taking account of the tax credit that comes with a dividend, a 40% taxpayer ends up paying income tax at a rate of 25% on dividends paid to him, whereas a basic rate taxpayer has no additional tax liability.

In other cases, one shareholder may have a particular expense to meet – say, a new car – and would like a larger dividend than their shares entitle them to.

There are two ways to achieve this: dividend waivers and 'alphabet' shares.

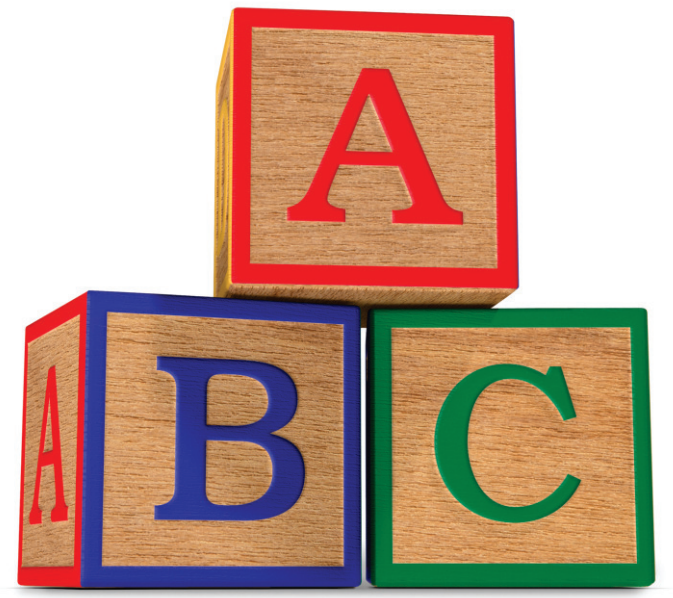
Dividend waivers

A shareholder can execute (lawyerspeak for sign) a formal document waiving his right to a dividend, meaning that there are potentially more profits to be paid out as dividends to the other shareholders. Typically, this is done just before the dividend concerned is due to be paid, and it is important to get the timing and the formalities right, but that is not the point of this article.

The risk with a dividend waiver is that HMRC can challenge it as a 'settlement', which means an arrangement whereby the potential to receive income is transferred from one individual to another. Where a settlement benefits a spouse or minor child, the income concerned can still be taxed on the 'settlor' – the shareholder who waived the dividend.

HMRC can also attack in other circumstances, though there is considerable legal disagreement about how far such a challenge can go.

The point about dividend waivers is that HMRC are highly suspicious of them, and are likely to look very closely at what has gone on to see if they can attack it in any way.



'Alphabet' shares

This involves each shareholder having a different class of shares – for example, father has 35 'A' ordinary £1 shares, mother has 35 'B' ordinary £1 shares, and daughter has 30 'C' ordinary £1 shares.

When it comes to distributing the company's profits, separate dividends of different amounts per share can be declared for each class of share, so a dividend of £10 per share (or nil per share, but this is perhaps a bit provocative) can be declared on father's A shares (he's the 40% taxpayer), £1,000 per share on mother's B shares (she has no other income), and £500 per share on daughter's C shares (she wants a car).

It is much harder for HMRC to challenge this arrangement, because there is clear case law (the famous 'Arctic Systems' case) that says that this is not caught by the 'settlements' legislation, and I have only ever seen it challenged in extreme cases involving highly paid executives whose large bonuses were paid using alphabet shares in a company set up for the purpose.

Practical Tip:

If you want the ability to vary the dividends paid to each shareholder, alphabet shares are much simpler than dividend waivers, and much less likely to be challenged by HMRC.

Personal Tax

Registering Your Rental Losses

If you rent out property then you have an obligation to report the property income and expenses to HMRC (see **www.hmrc.gov.uk/report-changes/individual/income.htm#2**).

You will need to tell HMRC that you are receiving income from property by 31 January after the end of the tax year in which the income is received. You may need to complete a Tax Return, in which case HMRC will notify you of the need to file a Return. However, if you have PAYE earnings, you may be able to have any tax due collected via an adjustment to your PAYE code.

Even if you make a loss it is to your advantage to report this to HMRC. Many people do not realise this and only start reporting the income when they break into profit.

Without reporting the rental losses, you are losing out on being able to set these losses against future income from property, meaning that you will pay more tax than you should.

So if you register these losses now, you will be able to take them forward and offset them in future years.

Case Study:

Harry starts letting out a property in 2008.

For each of the first five years, he calculates a loss of £1,000 per annum and declares this loss on his Tax Return.Due to changes in mortgage rates and a rise in rental income from the property, he realises a profit of £2,500 in each of the years 2013 and 2014, which he also declares.Because he has declared the losses in the previous five years, he utilises the losses against the income and saves tax on this income.

Assuming Harry pays tax at 40%, the saving by using the losses is £2,000 (a saving of £1,000 in each year (£2,500 @ 40%)).

Property Tax

Exchange Of Interests

If a gift of property is made to a non-spouse/civil partner, Capital Gains Tax(CGT) is charged on the donor as if the market value had actually been received.

However, in a situation where joint owners of property wish to become sole owners of part, then provided no money changes hands, a form of 'reinvestment relief' can be applied and no CGT charged. The joint owners are treated as if each had sold their share for its market value and then the proceeds 'reinvested' in acquiring the other's half share.

If the properties are not of equal value or if one of the joint owners pays extra for a higher percentage share, CGT will be charged on the person receiving payment equivalent to the actual amount paid.

Case Study:

Alan and Brian (who are not connected persons) jointly own two rental properties, Greengables and Whitegables, respectively. Each property was originally inherited at market values of £50,000 each. They decide to exchange their joint interests such that Alan acquires the sole interest in Greengables and Brian secures exclusive title to Whitegables. At the time of exchange Greengables has a market value of £200,000; Whitegables a value of £250,000. No cash changes hands, but Brian has obtained the more valuable interest, and therefore greater proceeds, for the disposal of his share.

Cost for future CGT purposes = Cost of original ½ share + deemed cost of ½ share in exchange:

Alan's calculation:

MV consideration	£100,000
Less cost	£(25,000)
Less 'reinvestment'	£(75,000)
Gain	NIL

Brian's calculation:

MV consideration	£125,000
Less cost	£(25,000)
Less 'reinvestment'	£(75,000)
Chargeable Gain on exchange	£25,000

Cost for future CGT purposes for both properties: **£25,000 + £25,000 = £50,000**

Business Tax

Post-Cessation Receipts And Expenses

Income tax is charged on post-cessation receipts arising from a trade, profession or vocation to the extent it is not otherwise charged to tax. A post-cessation receipt is a receipt that a person receives after a trade has been permanently discontinued which arises from the carrying on of the trade before cessation.

In computing the amount that is charged to tax a deduction is given for losses and expenses or debits that would have been deductible had the trade continued. No deduction is given for amounts arising directly or indirectly from the cessation itself.

Case Study:

After the cessation of the trade, John receives a payment of £5,000 in respect of an unpaid invoice arising from the trade which has been written off as a bad debt. He incurred costs of £500 in recovering the debt. He is taxed on £4,500, being the amount of the receipt less the cost of recovery.