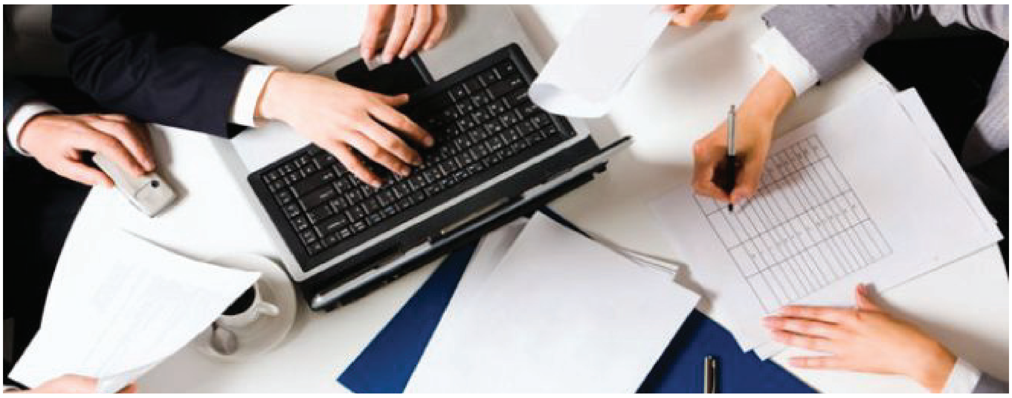
DUFTON KELLNER
CHARTERED ACCOUNTANTS

AUTUMN 2016

What Is The Optimal Salary Level For 2016/17?



Traditional profit extraction strategies for family companies are based on taking a small salary to maintain your contributions records and extracting profits above that level. To ensure that the year counts for contribution purposes, the salary needs to be at least equal to the lower earnings limit for Class 1 National Insurance contributions (NICs).For 2016/17, this is set at £112 per week - equating to an annual salary at least £5,824 for the tax year.

From 2016/17, the National Insurance employment allowance is no longer available where the sole employee is a director. This means that one man companies (such as a typical personal service company) no longer qualify.

Consequently, the optimal salary for 2016/17 will depend on whether or not the employment allowance is available.

Scenario 1
Employment allowance is not available

This will be the case in a one-man company where the employee is the sole director (or where the employment allowance is used up elsewhere).

It is assumed that the director has no other income and the personal allowance is fully available.

The maximum salary that can be paid free of NICs is equal to the lower of the primary and secondary threshold – for 2016/17, this is equal to £8,060 a year. At this level, the salary can also be paid free of tax (as it is covered by the personal allowance). The salary is deductible for corporation tax purposes (generating a tax saving for the company of £1,612).

However, mathematically, a marginally better result can be achieved by paying a salary equal to the secondary threshold of £8,112 per year. Although employee contributions are payable to the extent the salary exceeds £8,060 – giving rise to a NIC bill of £6.24 a year (i.e. 12% (£8,112 - £8,060)), the additional salary in excess of the primary threshold (i.e. £52) is deductible for corporation tax purposes, generating a corporation tax saving of £10.40 (i.e. £52 @ 20%). Consequently, there is an overall saving of £4.16 by paying a salary of £8,112 rather than one of £8,060. However, as this necessitates the hassle of paying primary NICs of £6.24 over to HMRC, it is probably not worth it.

Tip:

Where the employment allowance is not available, for practical purposes the optimal salary is £8,060 a year. However, it is possible to save an additional £4.16 by paying a salary of £8,112, but this is perhaps more hassle than it is worth!

Scenario 2
Employment allowance is available

This will be the case if there is more than one employee (or the only employee is not also a director). It is assumed that the employment allowance is not fully utilised elsewhere. The availability of the employment allowance makes it beneficial to pay a salary equal to the personal allowance - £11,000 for 2016/17. Although employee's NIC is payable on the salary in excess of the primary threshold (£8,060), the employer's NIC liability that would otherwise arise on the salary in excess of £8,112 (i.e. £398.54, being 13.8% of £11,000 - £8,112) is covered by the National Insurance employment allowance. At a salary of £11,000, employee NICs of £352.80 (12% (£11,000 - £8,060)) is payable.

However, as salary is deductible for corporation tax purposes, the additional salary of £2,940 (£11,000 - £8,060) paid in excess of the primary threshold saves corporation tax of £588 (£2,940 @ 20%). This more than outweighs the employee's NICs of £352.80, generating an overall saving of £235.20. It is not worth paying a salary in excess of the personal allowance even if the employment allowance is available. Any salary above the personal allowance will be taxable and the combined effect of tax at 20% and employee's National Insurance at 12% will outweigh the corporation tax saving of 20%.

Tip:

If the employment allowance is available, the optimal salary is equal to the personal allowance of £11,000 (assuming this is not utilised elsewhere).

Special cases – Director under 21

No employer NICs are payable in respect of an employee under the age of 21 until the employee's earnings exceed the upper secondary threshold for under 21s of £43,000. Therefore, where the director is under 21, the optimal salary is equal to the personal allowance of £11,000, even if the employment allowance is not available.

Practical Tip :

As a general rule of thumb, the optimal salary (for 2016/17) is £8,060 if the employment allowance is not available, and £11,000 if it is (or the director is under 21) – but remember to take all personal circumstances into account.

IN THIS ISSUE

Dufton Kellner Limited
Barnston House,
Beacon Lane,
Heswall,
Wirral
CH60 0EE

Hotels, Guesthouses And Motels Are Trading – Aren't They?

The question whether an individual's activities constitute a 'trade' or a 'business' can be an important one for tax purposes. For example, loss relief against the taxpayer's other income (i.e. 'sideways' loss relief) is generally available in respect of trading losses, but not rental property business losses.

Holiday cottages

In the recent case *Nott v Revenue & Customs* [2016] UKFTT 0106 (TC), the taxpayer owned an estate including a 'manor' house, gardens, a farmyard area which included working farm buildings, and holiday accommodation units. There were eight units in total on the estate, six of which were holiday 'cottages'. The taxpayer owned all but one of the six cottages (the other was owned by his sister). There were two residential cottages on the estate, one of which was occupied by the taxpayer as his home.

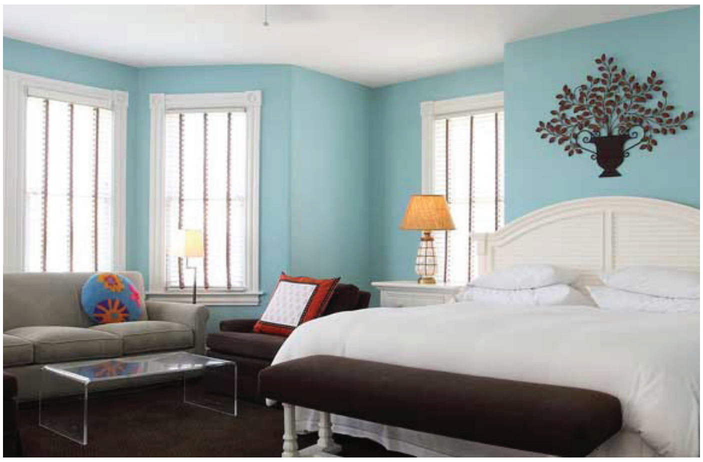
The holiday cottages were generally let for two weeks or less. Cooked breakfasts were offered, usually for an additional charge. A daily cleaning service was also offered, on request and for an additional charge. Other facilities available to guests included: recreational grounds; a 'working farm' environment including guided tours for children; a 'concierge' service; a pool and pool house; and a games area.

Following an enquiry into the taxpayer's tax return for 2009/10, HMRC concluded that the income from the holiday cottage complex was property income from furnished holiday lettings, such that losses from that activity could not be set against the taxpayer's income from other trades for Class 4 National Insurance contributions purposes (n.b. sideways relief for such losses also generally ceased to be available for income tax purposes from 2011/12). The taxpayer appealed.

Trading or property income?

In considering whether the income from the holiday cottage complex was trading or property income, the First-tier Tribunal was referred to several cases. The taxpayer and HMRC both argued that case law identified two factors which should be given particular weight in distinguishing property and trading income; firstly, whether the taxpayer was in *occupation* of the property; and secondly, the level of *services* provided to guests by the taxpayer in relation to that property.

On the first issue of occupation, the tribunal concluded that the taxpayer did not 'occupy' each of the units. The taxpayer had contended that the estate, including the units, should properly be viewed as a single parcel of land, of which he was the occupier. However, the tribunal considered that argument unsustainable, because the estate was not comprised solely of the units. On the second issue of the additional services provided, the tribunal considered that they were largely consistent with the services normally provided by a landlord of furnished holiday accommodation. The taxpayer's appeal was dismissed.



A worrying comment

The taxpayer in *Nott* also argued that his activity was, in all material respects, indistinguishable from that of many hotels and bed and breakfast establishments. The tribunal noted that some hotels provide very little in the way of additional services, while at the other end of the spectrum luxury hotels have available to rent self-contained properties within their grounds. The tribunal commented: 'We would observe in passing that HMRC's practice of treating all hotels and bed and breakfasts as trades may be unduly simplistic.' Whilst this comment was *obiter*, and although decisions of the First-tier Tribunal do not create a binding precedent, it is a potentially worrying observation, as it could encourage HMRC to challenge the trading status of such establishments.

Practical Tip :

The tribunal considered that some 'guiding principles' were derived from authorities summarised in *Maclean v Revenue and Customs Commissioners* [2007] STC (SCD) 350. One such principle offers a helpful clue on establishing a trade: 'Activities over and above the mere exploitation of heritable property or turning to profitable account the land, of which he is the owner, may be significant enough to classify a man's business as a trade. Whether the provision of services or other activities are significant enough to cross the line between land ownership and commercial enterprise in land is a question of fact and degree depending upon the *nature and extent of the operations or activities concerned'* (emphasis added).

Selling Future Business Profits: Income Or Capital?

Turning income receipts into capital has been potentially attractive to individual taxpayers for many years. This is mainly due to the difference between the rates of income tax (i.e. higher and additional rates 40% and 45%) and capital gains tax (i.e. higher rate generally 20% for 2016/17, based on changes in Finance Bill 2016).

Ingenious and creative minds have long been trying to devise ways of achieving this objective. Generally speaking, tax 'loopholes' these days tend to be blocked with anti-avoidance legislation very soon after HM Revenue and Customs (HMRC) become aware of them. However, one set of anti-avoidance provisions, aimed at blocking particular attempts to turn income into capital, has been with us in various forms for decades. Unfortunately, the rules are not very well known, and can therefore present an unexpected trap.

Selling occupation income

The anti-avoidance rules in question (ITA 2007, Pt 13, Ch 4) affect sales of occupation income.

For example, Robert, a VAT consultant (who pays income tax at 40%), sold a licence in respect of his consultancy fees for the next three years to another VAT practitioner on 1 February 2016, for a capital sum of £200,000. He declares the transaction as a capital receipt on his tax return for 2015/16. Is he correct to do so?

An income tax charge under the above anti-avoidance rules can apply where the transaction has been effected to exploit Robert's earnings capacity and a main object is the avoidance or reduction of an income tax liability (s 773(2)), if three conditions are satisfied. These conditions (A to C in the legislation) are broadly as follows (s 777):

• **Condition A** - The individual carries on an occupation wholly or partly in the United Kingdom;

• **Condition B -** Transactions are effected (or arrangements made) to exploit the individual's earning capacity in the occupation, by putting another person in a position to enjoy income or receipts from the individual's activities in the occupation (or anything derived from them); and

• **Condition C -** The transactions or arrangements result in a capital amount being obtained (by the individual or another person).

Payments for licences (or copyrights, or franchises) are specifically caught if the value of the right is derived from the individual's activities. In the above example, Frank is trying to turn his income into a capital receipt, and each of the conditions A to C is satisfied. The capital sum would therefore fall to be charged to income tax on an 'arising' basis (i.e. in the tax year 2015/16, when the capital sum is receivable; s 778(3)).

Sales of going concerns

There is an important exemption from the income tax charge for sales of going concerns (s 784). This exemption applies to capital receipts for the disposal of assets (including any goodwill) or a partnership interest, if the value is attributable to a profession or vocation as a going concern. A similar exemption applies to the disposal of shares in a company.

However, this is subject to a further anti-avoidance rule. A potential restriction in the exemption applies broadly if the going concern value is derived to a material extent from future earnings attributable to the individual's activities in the occupation. The exemption only operates in those circumstances if the individual will receive full consideration for the future earnings (e.g. a partnership profit share, or employment income as a company employee (s 785)).

Practical Tip:

A further possible let-out from the income tax charge is that it applies to an 'occupation'. This means that activities of a kind undertaken in a profession or vocation are caught, whether as a self-employed individual, an employee or office holder (s 774). The anti-avoidance rules were probably intended to affect individuals such as actors and sportsmen (e.g. see *Black Nominees Ltd v Nicol* (and *cross-appeal*) [1975] Ch D 1975, 50 TC 229), but professionals such as accountants and solicitors are also potentially within the scope of the provisions. However, trading activities fall outside them.

Personal Tax

Children's Income

Income earned from gifts from parents is exempt if less than £100 per annum. Otherwise the income is taxable as that of the parents.Consider gifting sufficient capital to generate this amount in income or utilise tax-exempt savings products to build up savings for the children.

This limit can be overcome by putting money into a Junior ISA or by investing in Children's Bonds, which generate a tax-free return.

Gifts can be made by grandparents to grandchildren without restriction.

Case Study:

John is a higher rate taxpayer (paying tax at 40%) and gifts each of his children £2,000, which is placed in a children's account for them and earns £80 interest per annum.

As this is less than £100 it is not taxed as John's income. John therefore saves £32 per annum in tax which he would have otherwise paid on the interest income had the money been placed in an account in his own name.

Property Tax

Joint Investors

Joint ownership exists where two or more persons own property together. Therefore, individuals who purchase property jointly intending to rent for the long term are 'joint investors' being taxed on their share of the annual rental profits made or gains made on sale. Joint owners of property purchased with the intention to sell after restoration are likely to be in a 'trading partnership' with each being taxed as a self-employed 'property dealer'.

The difference between joint investors and a trading partnership is that for a partnership to exist there needs to be a degree of organisation similar to that required for an ordinary commercial business with a view to making a profit. A partnership agreement is therefore recommended.

Non-tax reasons for buying as joint investors:

- Sharing of the investment.
- Control and running of the properties is shared.
- If owned as joint tenants, on death the property is transferred automatically to the joint investor owner who may not be one's next of kin.
- Funding for the investment is not possible as a sole investor.

Tax position:

Correct tax planning can enable the reduction of the total tax liability. The letting profit is divided with each owner's share of the profit being taxed at his or her respective marginal rate.

The example shows the tax position should one owner be taxed at a higher rate than the other.

Case Study:

Joanne and Robert are married and own a portfolio of rental properties 50:50.

For the year 2015/16 Joanne is a basic rate taxpayer but Robert is a 45% additional rate taxpayer. Total net rental profit is £825 per month, i.e. £9,900 per year = £4,950 each.

Joanne: Tax liability of £990 (£4,950 @ 20%).

Robert: Tax liability of £2,227.50 (£4,950 @ 45%).

If Robert owned the properties as a sole investor the tax liability would be £4,455; by owning the properties jointly with Joanne, there is a tax saving of £1,237.50. (The saving could be even higher, should the property be solely in Joanne's name.)

Business Tax

Small Loans To Directors

Making a loan to a director can be advantageous.

Under the benefit in kind rules, no tax charge arises in respect of an employment-related loan if the balance outstanding on the loan does not exceed £10,000 at any point during the tax year.

This means that it is possible for a director to enjoy a tax-free loan of up to £10,000 for up to 21 months free of charge.

Beware of the temptation to repay the loan and immediately re-borrow the money as HMRC may issue a challenge as anti-avoidance provisions render repayments of more than £5,000 ineffective if the funds are re-borrowed within 30 days.

Case Study:

Oliver is a director of a family company. The company prepares accounts to 31 May each year. In July 2015 the company agrees to lend him £10,000 to take his family on holiday. As long as he repays the loan by 1 March 2017 he will be able to enjoy the money tax free.

Email:post@duftonkellner.co.uk • Tel: 0151 342 6405 • www.duftonkellner.co.uk