

**TAX SUPPORT FOR  
PROFESSIONALS**

# TAX INSIGHT

Practical advice for businesses,  
their owners and professional  
advisers

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## ► IN THIS ISSUE

<b>BEATING THE 50 PER CENT RATE – I</b>	<b>02</b>
Dividends - getting it right	
<b>BEATING THE 50 PER CENT RATE – II</b>	<b>04</b>
Service companies – are they worth it?	
<b>TRUSTS AND WILLS</b>	<b>06</b>
Some welcome modernisation	
<b>PARTNERSHIP LOSSES</b>	<b>08</b>
When is capital 'receivable'?	
<b>TAILPIECE</b>	<b>10</b>
30 per cent of what?	
<b>SUPPLEMENTARY TECHNICAL NOTES</b>	<b>11</b>

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## ► BEATING THE 50 PER CENT RATE – I

### Dividends – getting it right

The payment of dividends before rather than after 6 April 2010 is a relatively straightforward way of taking pre-emptive action to avoid the 50 per cent income tax rate that will apply to incomes of over £150,000 in 2010/11. However, as with all tax planning measures, care is needed when implementing it. HMRC is likely to check at least some dividend payments made in the run-up to 5 April 2010, so companies must ensure that they 'dot the i's and cross the t's'.

#### How to go about it?

The early payment of dividends could cause cash flow problems. However, if a company has sufficient cash to pay a dividend, it could do so and, if necessary, borrow some or all of the cash back from shareholders. Alternatively, in the case of directors, a credit to a loan account would constitute payment for tax purposes, provided all formalities are met.

It is, of course, critical that a dividend payment is correctly implemented so that the payment date for income tax purposes is before 6 April 2010.

#### General considerations

- Companies can decide how dividends are declared. Normally, the Articles of Association provide that dividends are to be declared by an ordinary resolution, but that the directors can declare interim dividends.
- Directors must, before declaring a dividend, satisfy themselves that the company has sufficient distributable reserves to pay the dividend. A final dividend is normally declared on the basis of the accounts for the previous accounting period, so it may be necessary to draw up interim accounts before declaring an interim dividend.
- The declaration of a dividend and payment of a dividend are two quite separate processes.

- An interim dividend can normally be varied or rescinded at any time before it is paid.

### Date of payment

Individuals are charged to income tax on the amount of dividends 'paid' in the tax year. For corporation tax purposes, the legislation states that dividends are treated as paid on the date when they become due and payable, but there is no similar provision that defines the date of payment for income tax purposes.

In a 1970 case, it was held that a dividend forms part of a person's total income when the dividend becomes due, and that is when payment becomes enforceable. The declaration of a dividend by a company in general meeting creates an enforceable debt – immediately, if no payment date is specified, or at a future specified payment date. As an interim dividend can be varied or rescinded at any time before it is paid, there is no enforceable debt, and the dividend will only be 'due and payable' for income tax purposes when it is actually paid.

So, to summarise:

- A **final dividend** is treated as paid for income tax purposes on the date on which it is stated to be payable or, if there is no specified payment date, on the date on which it is declared.
- An **interim dividend** is treated as paid for income tax purposes on the date on which it is actually paid.

### Interim dividends - payment methods

The payment of an interim dividend by way of a **credit to a shareholder's loan account** will be effective on the date on which the relevant entries are made in the company's records. Particular care should therefore be taken to record the appropriate entries at the correct time, and not wait until the annual accounts are prepared at a later date.

Where an interim dividend is paid **by cheque**, payment is effected on the date on which the company posts the cheque to the shareholder.

## ► BEATING THE 50 PER CENT RATE – II

Service companies – are they worth it?

**One way in which partnerships and LLPs can mitigate the effect of the proposed 50 per cent top income tax rate is to use a service company to pay employees and perhaps carry out other administrative functions. We make a quick cost/benefit comparison and consider some of the main issues.**

### The benefits

Partnerships and LLPs have used service companies in the past, but the introduction of the 50 per cent rate will increase their attractiveness, as the effective differential tax/national insurance rate will increase from 13 (41 – 28) per cent to 23 (51-28) per cent. The main cost which can be transferred from the partnership to the service company is normally the payment of employees' salaries. However, it may be possible to route other administrative and non tax allowable expenditure through the service company, which would maximise the benefit.

Typically, a mark-up of between 4 – 6 per cent for the services provided can be agreed with HMRC, but it may be possible to agree a higher mark-up if, for example, assets are transferred to the company or if the company bears additional risks.

### Example

For an LLP with employee costs of £6m the mark-up at, say, 5 per cent would be £300,000. This will save partnership tax and national insurance, at 51 per cent, of £153,000, and the company will pay corporation tax, at 28 per cent, of £84,000. The annual saving would therefore be £69,000.

### The method

There are two possible ways of operating the arrangement.

1. The partnership pays the company at cost for the services provided, and a transfer pricing adjustment is made to reflect the arms length price. The advantage with this method is that profits

do not accumulate within the company, which avoids a possible double tax charge when profits are extracted. It may even be possible to agree with HMRC to dispense with the actual transfer of any monies at all to the company, resulting effectively in an HMRC-approved 'paper' tax-saving arrangement.

2. The partnership pays the company at cost plus mark-up for the services provided. The main advantage is that this avoids the cost of preparing a transfer pricing report, so it may be suitable for small partnerships, especially where the partners are happy for the company to accumulate profits.

### **The cost**

Total set-up costs, consisting of legal and accounting costs and the preparation of a transfer pricing report, would range from £25,000 - £50,000, depending on the size of the partnership. The main element of the cost is the preparation of a transfer pricing report, so if this is not required, total costs will be much lower. In addition, legal partnerships may well be able to deal with all legal aspects in-house, further reducing the cost.

### **Some issues**

- Employment contracts will need to be transferred from the partnership to the service company. Although this is a relatively straightforward matter under the Transfer of Undertakings (Protection of Employment) (TUPE) regulations, it does need to be carefully addressed, to allay any employee concerns. A simple letter advising each employee of the formal transfer of employment, complying with the TUPE information requirements, will normally be sufficient.
- Pension scheme implications need to be considered.
- A new PAYE scheme will need to be established.
- The company's corporation tax liability may need to be funded, depending on the chosen structure.

### **Conclusion**

If the differential between the top income tax and corporation tax rates remains in the future, a service company will provide a worthwhile ongoing saving – the larger the partnership, the larger the saving. Smaller partnerships with fewer employees might wish to consider establishing a corporate partner as an alternative – this will be less costly to implement and will provide more flexibility in the allocation of partnership profits.

## ► TRUSTS AND WILLS

Some welcome modernisation

**The Perpetuities and Accumulations Act 2009 may sound like something gathering dust in a Dickensian-style lawyer's office, but this new Act does have some practical modern-day implications. Advisers have an opportunity to prompt clients to review their affairs and perhaps make some amendments.**

### **How long can this continue?**

England and Wales, unlike some other jurisdictions, places limits on how long assets can be held in a trust (the perpetuity period), and how long income can be accumulated within a trust (the accumulation period).

Currently, the perpetuity period can either be a fixed period of 80 years from the date of establishment of the trust, or a period equal to the lifetime of a specified person who is alive when the trust is established, plus 21 years. The maximum income accumulation period (except for charities) is currently only 21 years.

These rules were designed to limit the length of time that wealth can be tied up within a trust, on the basis that it is not in the 'public interest' for there to be uncertainty as to the ownership of assets for an unlimited period of time.

### **What's changing?**

For new trusts and wills executed from 6 April 2010, the perpetuity and accumulation periods will both be extended to 125 years – an increase of 45 years for the perpetuity period, but a much more significant increase of 104 years for the accumulation period.

### **What does it mean?**

- The main implication for individuals is that trustees will be able to accumulate income for a longer period, for example if they do not wish to distribute income to immature or irresponsible beneficiaries. There will also be more flexibility to provide for the long-term needs of disabled individuals.

- In the commercial world, the extended accumulation period will simplify some property arrangements by allowing option periods of more than 21 years, and generally allow more flexibility for longer-term planning and development.
- In recent years, many settlors have chosen to establish trusts under the law of another jurisdiction, with longer perpetuity and accumulation periods than permitted in England. More settlors may now be happy to establish trusts under English law, although some jurisdictions, such as Jersey and Bermuda, permit even longer perpetuity and accumulation periods.

### **What about existing trusts and wills?**

The new rules will not be retrospective – the perpetuity and accumulation periods specified in documents executed before 6 April 2010 will remain unchanged. However, it will be possible to amend existing arrangements in two ways:

- A will can be amended and effectively 'republished' by adding a codicil, which could alter the perpetuity and accumulation periods specified in a will trust.
- Where the perpetuity period in an existing trust is uncertain, because it is based on the life of a person in being, it will be possible to extend it to 100 years.

### **What now?**

This could be a good opportunity for advisers to ask clients to review trust and will arrangements as part of a more general review of their affairs.

## ► PARTNERSHIP LOSSES

When is capital 'receivable'?

**In the October 2008 edition of Tax Insight we summarised the various income tax loss relief restrictions for members of partnerships and limited liability partnerships (LLPs) that carry on a trade (but not professional practices). Here, we look in more detail at one aspect.**

### **A question of capital**

Sideways loss relief for all partners and members of all general and limited trading partnerships and LLPs, except active partners in general partnerships, may be restricted to the amount of their capital contribution. For non-active partners in general partnerships, the restriction applies to losses arising in the first four years of a trade; in the other cases, it applies to losses arising in any year. 'Capital contribution' is defined differently for different types of partner – see the Supplementary Technical Notes.

This restriction is particularly important for active and corporate members of LLPs and corporate partners in limited partnerships, as they are not subject to the overall £25,000 sideways loss relief restriction that applies to all other partners except active partners in general partnerships.

### **Excluded capital contributions**

For all types of partner, the amount of a capital contribution is excluded if the partner has already received or withdrawn it by the end of the basis period or accounting period for which the loss is claimed. It is also excluded if it is received or withdrawn in the five years starting with the time at which the amount of the contribution is being calculated. Those provisions are quite clear. (The five year rule is designed to prevent temporary increases in contributions in order to obtain loss relief.) Furthermore, a contribution is excluded if the partner can request another person to reimburse it at any time, which again is understandable.

However, there is one other exclusion whose effect is not so clear. This is where the partner 'is or may be entitled to receive' the amount of the contribution 'at any time when they are carrying on the trade as a member of the partnership'. At first sight, it might appear that this exclusion would deny any loss relief, as most partnership deeds

do not preclude the withdrawal or repayment of capital while the individual is still a partner. However, it appears that HMRC has not taken that point up to now, so it can perhaps be inferred that this restriction is intended to catch any unspecified arrangements to return capital earlier than would normally be the case.

## **Conclusion**

In light of the capital contributions restriction, prospective and existing trading partnerships should review proposed and existing partnership or LLP deeds and think carefully before including (or retaining) any clauses which refer to an entitlement to withdraw or receive capital, unless they are considered essential. For example:

- We have seen deeds which prevent the withdrawal of capital until the repayment of bank borrowings. Although that is intended as a prohibition, it could also be taken as an implicit entitlement to withdraw capital once borrowings have been repaid.
- Some deeds also contain a clause to the effect that the partners can from time to time increase or reduce capital, with resulting additional contributions or repayments. Once again, such a clause tends to suggest that capital may be repaid, and it may be better to dispense with such provisions if they are not really necessary.

## ► TAILPIECE

### 30 per cent of what?

**The Enterprise Investment Scheme (EIS) has been around for 16 years. Somewhat surprisingly, a fairly fundamental definition has only now been clarified by the First Tier Tribunal.**

Most advisers will know that EIS investors cannot obtain income tax relief on the cost of their shares if they are 'connected' with the issuing company during a prescribed period. For this purpose, individuals may be connected with a company if they are an employee, director or partner of the company or a subsidiary or, with certain exceptions, if they own, or are entitled to acquire, more than 30 per cent of the issued ordinary share capital of the company or a subsidiary. No dispute there.

Similarly, an individual will be treated as connected if they own, or are entitled to acquire, more than 30 per cent of the voting rights in the company or a subsidiary.

Less commonly, an investor will also be treated as connected if they own more than 30 per cent of the 'loan capital and issued share capital' of the company or a subsidiary. But what does that mean?

Well, for a start, 'issued share capital' consists of all types of shares, as opposed to the simple '30 per cent of issued **ordinary** share capital' test. Now to the maths - what if an investor owned, or was entitled to acquire, more than 30 per cent of the issued shares, but less than 30 per cent of the loan capital? Or vice versa? That is what the recent tribunal case concerned – the investors held more than 30 per cent of the loan capital, but 'well below' 30 per cent of the issued shares.

HMRC argued that 'more than 30 per cent of the 'loan capital and issued share capital' means 'more than 30 per cent of the company's loan capital and issued share capital **combined**', and that the taxpayers in this case were connected with the company. However, the taxpayers contended that an investor is only connected if they hold more than 30 per cent of the issued shares **and** more than 30 per cent of the loan capital.

The tribunal agreed with the taxpayers, stating that if Parliament had intended the 30 per cent test to refer to the loan and share capital combined, it would have said so, and it would have given specific instructions as to how the two different elements were to be combined.

So now (after 16 years!) we know.

## ► SUPPLEMENTARY TECHNICAL NOTES

**These notes supplement the articles in Tax Insight, and are in the same sequence as the material in the articles. The notes incorporate references to statutory and other authorities, and the abbreviations used are those conventionally adopted by taxation advisers.**

### BEATING THE 50 PER CENT TAX RATE - I

Individuals are charged to income tax on the amount of dividends 'paid' in the tax year.

S 384 ITTOIA 2005

For corporation tax purposes, dividends are treated as paid on the date when they become due and payable.

S 834(3) ICTA 1988

A company can only make a distribution out of its accumulated realised profits less its accumulated realised losses.

S 830 Companies Act 2006

The declaration of a dividend and payment of a dividend are two quite separate processes. A dividend forms part of a person's total income when the dividend becomes due, and that is when payment becomes enforceable. The declaration of a dividend by a company in general meeting creates an enforceable debt – immediately, in the absence of a specified payment date, or at a future specified payment date. An interim dividend can be varied or rescinded at any time before it is paid, so if no payment date is specified, no enforceable debt is created.

Potel v Commissioners of Inland Revenue [1971] 2 All ER 504

Where a dividend is paid by cheque, payment is effected on the date on which the company posts the cheque to the shareholder.

Thairwall v Great Western Railway [1910] 2 KB 509  
HMRC Company Taxation manual CTM20095

### TRUSTS AND WILLS

From 6 April 2010 the perpetuity and accumulation periods for trusts (except charitable trusts) will be extended to 125 years. Where the perpetuity period in an existing trust is uncertain, because it is based on

the life of a person in being, it will be possible to extend it to 100 years.

Perpetuities and Accumulations Act 2009  
SI 2010/37

## **PARTNERSHIP LOSSES**

Definition of 'capital contribution':

Non-active partner in a general partnership or LLP (S 111 ITA 2007)

The calculation is made at the end of the basis period for the tax year in which the loss arose. The capital contribution is the amount contributed to the firm as capital, (including profits that have been added to capital), less any amount that the partner:

- has received back either previously or within the next five years
- is or may be entitled to receive at any time when he is carrying on the trade as a member of the partnership
- is or may be entitled to require another person to reimburse to him.

Amounts are not treated as received back if they are chargeable to income tax as profits of a trade.

Capital contributions do not count where the contribution is:

- financed by a loan or other arrangement under which the full financial cost is not borne by the partner. This applies to losses arising in basis periods beginning on or after or straddling 2 December 2004
- made mainly or partly for the purpose of obtaining losses that qualify for sideways relief. This applies to contributions made on or after 2 March 2007.

Individual limited partner (S 105 ITA 2007)

The calculation is made at the end of the basis period for the tax year in which the loss arose. The capital contribution is:

- the amount contributed to the firm as capital, (including profits that have been added to capital), less any amount that the partner:
  - has received back
  - is or may be entitled to receive at any time when he is carrying on the trade as a member of the partnership
  - is or may be entitled to require another person to reimburse to him
- any share of trading profits not yet received in money or money's worth.

Amounts are not treated as received back if they are chargeable to income tax as profits of a trade.

Capital contributions do not count where the contribution is:

- financed by a loan or other arrangement under which the full financial cost is not borne by the partner. This applies to losses arising in basis periods beginning on or after or straddling 2 December 2004
- made mainly or partly for the purpose of obtaining losses that qualify for sideways relief. This applies to contributions made on or after 2 March 2007.

#### Corporate limited partner (S 118(3), ICTA 1988)

The calculation is made at the end of the accounting period in which the loss arose. The capital contribution is:

- the amount contributed to the trade as capital, less any amount that the partner:
  - has received back
  - is or may be entitled to receive at any time when it is carrying on the trade as a member of the partnership
  - is or may be entitled to require another person to reimburse to it
- any share of trading profits not yet received in money or money's worth.

#### Active LLP member (S 108 ITA 2007)

The calculation is made at the end of the basis period for the tax year in which the loss arose. The capital contribution is

- the amount contributed to the LLP as capital, (including profits that have been added to capital), less any amount that the partner:
  - has received back either previously or within the next five years
  - is or may be entitled to receive at any time when he is carrying on the trade as a member of the partnership
  - is or may be entitled to require another person to reimburse to him
- the amount of any liability on a winding up not already included in the amount contributed as capital.

Amounts are not treated as received back if they are chargeable to income tax as profits of a trade.

Capital contributions do not count where the contribution is:

- financed by a loan or other arrangement under which the full financial cost is not borne by the partner. This applies to losses

arising in basis periods beginning on or after or straddling 2 December 2004

- made by a non-active member mainly or partly for the purpose of obtaining losses that qualify for sideways relief. This applies to contributions made on or after 2 March 2007.

#### Corporate LLP member (S 118ZC ICTA 1988)

The calculation is made at the end of the accounting period in which the loss arose. The capital contribution is the greater of the amount subscribed and the liability on a winding up.

The amount subscribed is the amount contributed as capital, less any amount that the member:

- has directly or indirectly drawn out or received back either previously or within the next five years
- is or may be entitled to receive at any time when he is carrying on the trade as a member of the partnership
- is or may be entitled to require another person to reimburse to him.

The amount of the liability on a winding up is the amount which the member:

- is liable to contribute to the assets of the LLP in the event that it is wound up
- remains so liable for at least five years.

## TAILPIECE

An individual is connected with an EIS issuing company if he directly or indirectly possesses or is entitled to acquire more than 30 per cent of:

- the issued ordinary share capital of the company or any subsidiary
- the loan capital and issued share capital of the company or any subsidiary
- the voting power in the company or any subsidiary.

S 291(1) (b) ICTA 1988

An investor is only connected with a company under the test in S 291(1) (b) ICTA 1988 if they held more than 30 per cent of the issued shares and more than 30 per cent of the loan capital. If Parliament had intended the 30 per cent test to refer to the loan and share capital combined, it would have said so, and it would have given specific instructions as to how the two different elements were to be combined.

R Taylor & N Haimendorf v HMRC [2009] TC00277

## ► MEMORY JOGGER

An index covering three years from January 2006 to December 2009 was included in the December 2009 issue and appears at six-monthly intervals.

Readers may however like to be reminded here of some of the topics covered in recent issues – and where to find them.

Capital allowances	
■ Small pools allowance	Dec 09
Company cars	Jan 10
Employee benefit trusts	Sep 09
Enterprise investment scheme	Sep 09
Enterprise management incentives	Nov 09
Entrepreneurs' relief	Jul 09 Jan 10
Foreign dividends	Aug 09
IHT - Employee benefit trusts	Sep 09
Late paid interest	Nov 09
Management charges	Sep 09
Non-domiciled individuals	Feb 09 Jun 09 Sep 09 Nov 09

## Partnerships

- First principles - is there a partnership? Oct 09
  - Partnership property Oct 09
  - Partnerships and capital gains tax Oct 09
  - Corporate partners – points to watch Oct 09
  - Partnerships and VAT Oct 09
  - Partnerships and SDLT Oct 09
- 

Penalties Jan 10

---

## Pensions

- Pensions for high earners Aug 09
- 

Permanent establishment Jul 09

---

Pre-budget report 2009 Dec 09

---

Private residences Aug 09

---

Salary sacrifices scheme  
Nov 09  
Jan 10

---

Tax claim time limit changes Nov 09

---

Transferring a trade Jan 10

---

Unapproved share options  
Jul 09  
Nov 09

---

Unlawful dividends Jul 09

---

## VAT

- 1 January 2010 – what's happening? Jul 09
- Option to tax Aug 09
- Partnerships Oct 09

## ▶ **LOOKING AHEAD**

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