Taxation Update and Planning October 2017

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DIVIDEND ALLOWANCE

The current regime for taxing dividends has been in place since 6 April 2016. Under the rules, all taxpayers, regardless of the rate at which they pay tax, are eligible for a 'dividend allowance'. Although termed an 'allowance', in reality the dividend allowance is a nil rate band and dividends sheltered by the allowance are taxable at a zero rate. The allowance is set at £5,000 for 2016/17 and 2017/18, enabling all taxpayers to receive dividend income of £5,000 tax-free (on top of any dividends that are covered by the personal allowance). Once the dividend allowance (and the personal allowance) have been used up, dividends are taxed at 7.5% to the extent that they fall within the basic rate band, 32.5% to the extent that they fall within the higher rate band and 38.1% to the extent that they fall within the additional rate band.

The dividend allowance is to fall to £2,000 from 6 April 2018. This will impact on anyone who receives dividends, either from investments or as part of a profit extraction strategy from a personal or family company.

Dividends are a popular and tax-efficient method of extracting profits from a personal or family company. Where profits are extracted in this way, it is sensible to plan ahead to ensure that the higher dividend allowance available for 2017/18 is not wasted. Where shareholders in personal or family companies have taken dividends of less than £5,000 in 2017/18, and where retained profits are sufficient, consideration should be given to paying a dividend before 6 April 2018 in order to mop up any unused dividend allowance for 2017/18. For 2018/19 onwards, the allowance is only £2,000.

Paying a dividend after 6 April 2018 rather than before may mean (depending on the size of the dividend) that it is taxable where previously it was tax-free. Assuming that dividends of at least £5,000 continue to be paid in 2018/19 (and the personal allowance is utilised elsewhere), the reduction in the dividend allowance will increase the tax payable by a basic rate taxpayer by £225, a higher rate taxpayer by £975 and an additional rate taxpayer by £1,143.

Talk to us about tax-efficient profit extraction policies and the benefits of planning ahead.

TERMINATION PAYMENTS

The rules on the tax and National Insurance treatment of termination payments is changing from 6 April 2018.

Payments made on the termination of an employment are treated differently depending on whether the payment is a payment of earnings, such as normal wages and salary, or a compensation payment, such as damages for loss of office. Payments taxed as compensation payments benefit from a £30,000 tax-free exemption and are only taxable to the extent that they exceed £30,000. The £30,000 exemption does not apply to payments taxed as earnings.

It is not always easy to determine whether a payment is one of earnings or a compensation payment benefitting from the £30,000 exemption. In particular, payments referred to as 'payments in lieu of notice' cause difficulty in practice, not least because the term is used to describe payments that differ in nature. Under the current rules, payments in lieu which the employee is contractually entitled to receive, or which the employee has an expectation of receiving (for example, where there is a long standing company practice of making payments in lieu of notice), are taxed as earnings and do not benefit from the £30,000 exemption. By contrast, payments for which there is no contractual entitlement or expectation and which take the form of damages for the failure to give proper notice, benefit from the £30,000 exemption.

The treatment of payments in lieu of notice is to change from 6 April 2018 onwards. From that date, the payment is compared to the pay that the employee would have received had the employment continued throughout the notice period. Where the termination payment is not more than the pay that the employee would have received in the notice period had the employment not been terminated, it is taxable in full. Any excess over what would have been payable had the employment continued is treated as a compensation payment and will benefit from the £30,000 exemption. Essentially, any earnings payable until the end of the notice period are taxed in full as earnings from the employment.

The way in which compensation payments are treated for National Insurance purposes is also changing from 6 April 2018. Prior to that date, no National Insurance is payable on termination payments treated as compensation payments rather than as earnings. However, from 6 April 2018, employer National Insurance contributions will be payable on compensation payments made on the termination of employment to the extent that they exceed the £30,000 tax-free threshold – although the payments will remain free of employee's National Insurance. The employee will pay tax on compensation payments in excess of £30,000 (as now) and the employer will pay employer's National Insurance.

Please contact us to discuss the structuring of tax-efficient termination packages.

PAYE SETTLEMENT AGREEMENTS

A PAYE Settlement Agreement (PSA) is an agreement that an employer makes with HMRC under which the employer agrees to pay the tax and National Insurance on certain benefits and expenses provided to employees. The tax and National Insurance due under the PSA is paid in a single payment by 22 October after the end of the tax year to which it relates where payment is made electronically. An earlier date of 19 October applies to payments that are made by cheque.

A PSA can be useful to save work and also to preserve employee goodwill. Benefits and expenses included in the PSA do not need to be notified to HMRC on form P11D.

However, not all benefits are suitable for inclusion within a PSA – a PSA can only be used for payments that are made irregularly, payments which are minor (although this category is largely irrelevant following the introduction of the exemption for trivial benefits costing £50 or less) or where it would be impracticable to operate PAYE. For 2017/18 and earlier years it is necessary to agree a PSA with an officer of HMRC before 6 July following the end of the tax year to which it relates. However, HMRC are simplifying the PSA process and as part of this, it will no longer be necessary to agree the terms of the PSA in this way. Further reforms are planned. The current PSA process largely relies on paper forms but HMRC are to develop an automated PSA process as part of their digital strategy.

Please contact us to discuss whether a PSA would be suitable for your employees and whether it would save work for you at the year end.

CASH BASIS FOR LANDLORDS

Under the cash basis, accounts are prepared simply by reference to money received and money paid out. By contrast, under Generally Accepted Accounting Practice (GAAP) profits must be worked out using the accruals basis (sometimes referred to as the ‘earnings basis’) which recognises income earned in a period and expenditure incurred in a period, regardless of when the income is received or the payment made.

From 6 April 2017 onwards, the cash basis will be the default basis for most unincorporated landlords where rental income is less than £150,000 a year. However, if the landlord wishes to continue to prepare accounts on the accruals basis, he or she will need to elect to do so. By contrast, property letting companies will need to continue to use the accruals basis to prepare accounts.

The rules for the treatment of capital expenditure under the cash basis have also been reformed from 6 April 2017 onwards. The new rules allow landlords using cash basis accounting to deduct most capital items from rental income when computing profits. However, a deduction is not available in this way for all capital expenditure – notable exceptions include land and cars.

Contact us to discuss what cash basis accounting means for your property rental business.

VAT FLAT RATE SCHEME

The VAT Flat Rate Scheme for small businesses is a simplified scheme which allows eligible traders to calculate the VAT that they pay over to HMRC by reference to a fixed percentage applied to gross (i.e. VAT-inclusive) turnover. Businesses with VAT taxable turnover of £150,000 a year or less can join the scheme.

Prior to 1 April 2017 the flat-rate percentage was determined solely by reference to the trade sector in which the business operated. From 1 April onwards, it is also necessary to consider whether the business meets the definition of a ‘limited cost trader’. Where a company is a ‘limited cost trader’ the VAT that must be paid over to HMRC is at worked out using a higher rate percentage of 16.5% of gross (VAT-inclusive) turnover for the period, rather than the percentage for the relevant business sector.

A limited cost trader is one that spends less than 2% of its VAT-inclusive turnover on ‘relevant goods’ or one which spends more than 2% of its turnover but less than £1,000 a year on relevant goods. The 2% test must be applied for each VAT quarter. The test is a harsh one as it only takes account of expenditure on goods, not on services. Consequently, if a business spends a lot on VATable services but not much on goods, it may be classed as a limited cost business and may lose out in terms of recovering the VAT incurred on services.

If you use the flat rate scheme, contact us to arrange a review as to whether this is still beneficial.

COMPANY CARS

Despite rising tax bills, company cars remain a popular benefit. The rules for taxing company cars reward employees driving cheaper low emission models with a lower tax bill.

Until 5 April 2015, it was possible to drive an electric company car tax-free. However, after that date, electric cars have been taxed according to the appropriate percentage for the 0 to 50g/km emissions band (9% for 2017/18, rising to 13% for 2018/19).

Technological advances mean that electric cars are becoming a more viable alternative to petrol and diesel options. In recognition of this, new appropriate percentage bands are to be introduced from 2020/21 onwards for electric and other ultra-low emission vehicles. Under the new structure, the percentage applying to cars with emissions of 1 to 50g/km will depend on both the level of the car’s CO2 emissions and also its electric range, which is the distance that the vehicle can travel in pure electric mode. For vehicles with CO2 emissions of 51g/km and above, the appropriate percentage depends solely on the level of CO2 emissions.

The bands for ultra-low emission cars for 2020/21 onwards are as follows:

<table>
<tr><th>CO2 emissions</th><th>Electric range</th><th>Appropriate percentage</th></tr>
<tr><td colspan="2">0g/km</td><td>2%</td></tr>
<tr><td rowspan="5">1–50g/km</td><td>130 miles or more</td><td>2%</td></tr>
<tr><td>70 to 129 miles</td><td>5%</td></tr>
<tr><td>40 to 69 miles</td><td>8%</td></tr>
<tr><td>30 to 39 miles</td><td>12%</td></tr>
<tr><td>Less than 30 miles</td><td>14%</td></tr>
<tr><td colspan="2">51–54g/km</td><td>15%</td></tr>
<tr><td colspan="2">55–59g/km</td><td>16%</td></tr>
<tr><td colspan="2">60–64g/km</td><td>17%</td></tr>
<tr><td colspan="2">65–69g/km</td><td>18%</td></tr>
<tr><td colspan="2">70–74g/km</td><td>19%</td></tr>
</table>

Thus, a lower tax charge will apply to electric cars with a greater electric range.

When planning ahead for company car changes, it is important to consider the tax implications of any policy and of the models chosen for the car fleet. Please contact us for more information.