business UPDATE
Autumn 2007

Keens Shay Keens Limited
Chartered Accountants and Business Advisers

Cash: The Key to Business Success

"Cash is King". Perhaps one of the most understated truisms of modern business. Without cash a business cannot develop products, employ people, obtain sales or invest in assets. The ability to forecast a business' cash needs is fundamental to successful business management. Cash is derived from profits but profits do not necessarily equal cash – at least not immediately.

Lack of cash from profitable activities is often why businesses that should be prosperous struggle. The key to a cash rich business is managing its cash cycle (the time between paying for goods/services to receiving payment for goods/services – the "working capital" cycle). Most businesses can produce a basic profit forecast but addressing the working capital cycle requires paying attention to a document often missed in basic forecasting – the balance sheet.

The balance sheet addresses key issues such as how long it will take our customers to pay us, how long we can afford to wait to pay our suppliers and what statutory payments (e.g. VAT) must be made in the interim.

Identifying this cycle enables a business to understand its cash constraints and for those where profit does not immediately become cash how payments can be financed.

To accurately understand how a business will operate in the future Keens Shay Keens offer an integrated forecasts solution consisting of profit forecast, balance sheet and the resultant cashflows. If cashflow is your problem call us to find the solution.

Arctic Ruling Prompts Tax Law Change

Hot on the heels of the House of Lords' decision in favour of the taxpayer in the Arctic Systems Ltd case came a statement from HM Revenue & Customs (HMRC) that the law will be changed on 'the tax treatment of income splitting'.

In the Pre-Budget Report, the government announced that it would consult shortly on legislation to remove the tax advantage from shifting income to a person subject to a lower tax rate. It will take effect from 2008/09.

HMRC views it as 'unfair' that a person can reduce their tax liability on business earnings by paying dividends to a non-working spouse or civil partner – the issue at stake in the Arctic Systems case. The Pre-Budget Report indicated that the new rules would only apply to income in the form of dividends or partnership profits. Employment and savings income would not be affected. It was the settlements legislation that HMRC invoked in the Arctic Systems case.

The changes will not affect any income arising in 2007/08 or earlier. HMRC is now reviewing all cases kept open while awaiting the House of Lords' decision, and will settle them in accordance with the ruling. However, HMRC has pointed out that not all arrangements are exactly the same as in the Arctic Systems case, and has therefore promised to publish detailed guidance well before the 31 January 2008 deadline for the submission of 2006/07 tax returns. The guidance should also help in deciding on dividends to be paid in 2007/08.

The House of Lords rejected HMRC's argument that Mr Jones, the company director in the case, was taxable on dividends paid to his non-working wife. Nevertheless, they considered – in contrast to the Appeal Court – that the incorporation of Arctic Systems Ltd was a 'settlement' within the anti-avoidance rules, because its purpose was to share income and therefore reduce tax. However, Mr Jones could not be taxed on dividends paid to his wife because of the exemption for an outright gift of property between spouses. The House of Lords then rejected HMRC's argument that the ordinary share held by Mrs Jones was only a right to income – and therefore outside the exemption – because the share also conferred voting and other rights.

Some commentators have suggested that the exemption might be lost if dividends are paid into a joint bank account, because the donor's access to the income would mean there had not been an outright gift. Holding separate bank accounts is therefore a sensible precaution.

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tax ISSUES

Landlords Absorb Interest Rate Losses

Rising mortgage interest rates have left some buy-to-let investors facing a loss on their lettings. Owners of let property are taxable on their rental income, but can deduct from this expenses connected with the letting.

For most landlords, the biggest expense is the interest on the money borrowed to buy the property. Therefore, rises in interest rates, which generally cannot immediately be passed on to the tenant in increased rent, have a large effect on a landlord's net income.

Unfortunately, you cannot normally set a loss on property letting against other types of income. You can generally only carry forward such a loss and set it against future letting profits. You need to tell HM Revenue & Customs about the loss within five years and ten months of the tax year in which it occurred, normally by claiming it in your tax return.

There is, however, one special type of loss that you are allowed to set against other income of the tax year in which the loss occurred. Certain residential property in the UK on very short lets may qualify as a furnished holiday letting. The main conditions are that the property must be let commercially for periods not exceeding 31 days for at least 70 days a year and be available for letting for at least 140 days in that year.

Other expenses that owners can deduct from rent include the costs of repairing and maintaining the property, insurance, rent collection and providing services. There is also a landlord's energy-saving allowance of up to £1,500 per residential property for expenditure on certain types of insulation. A renewals allowance (which is basically 10% of the rental income) can be claimed if the property is furnished. For furnished holiday lettings, you can claim capital allowances on the cost of furniture and fittings.

One cost that you cannot deduct is the capital repayment element of a mortgage. Most buy-to-let mortgages are interest-only, so the whole monthly payment is tax deductible.

However, some people, such as those who let a property in which they previously lived, may pay a mixture of interest and capital repayment. If you have this type of mortgage, you need to check the annual statement from your lender to determine how much of your payment can be deducted.

The taxation of property is a complex area and there are many aspects, including some tax reliefs, that are not mentioned here. We shall be happy to advise you further.

Time Runs Out for Trustees' IHT Advantage

Trustees of accumulation and maintenance (A&M) trusts have only a few months left to make any changes to their terms which may be necessary to avoid incurring inheritance tax (IHT) on the trust assets.

From 6 April 2008, an A&M trust that was created before 22 March 2006 will be liable to IHT on assets leaving the trust and the ten-yearly periodic charge on assets remaining in the trust, unless its terms provide that the assets will go to a beneficiary absolutely at age 18.

If you baulk at giving absolute ownership of valuable assets to an 18-year-old, there is a halfway house. If the trust assets will pass absolutely to a beneficiary between the ages of 18 and 25, there will be an exit charge, but it will be based only on the period after the beneficiary's 18th birthday. The calculation is complicated, but the maximum possible charge is 4.2% of the value of the assets, and it will generally be much less than this or possibly even nil.

Trusts under which beneficiaries up to age 25 receive only a life interest in assets will move to the new IHT regime from 6 April 2008. As with most trusts created from 22 March 2006 onwards, the trustees will be liable to the ten-yearly periodic charge. The maximum tax rate is 6% but it will normally be lower. Where the value of the trust assets is less than the inheritance tax nil-rate band, currently £300,000, the periodic charge may be nil. There will also be exit charges on property leaving the trust.

Trustees should consider their circumstances well ahead of the 5 April 2008 deadline, as any changes to the trust deed must be made by that date, and the process can take some time. The first step is to determine how much tax the trust might have to pay under the new regime. You then have to consider whether avoiding that tax is worth what could be a risky transfer of absolute ownership to a beneficiary aged between 18 and 25. We can advise you on all the factors that you should consider.

Commercially Let Property and Taper Relief

The abolition of capital gains tax taper relief, announced in the Pre-Budget Report, removes an important investment advantage of commercial property over residential property. The imposition of a flat 18% capital gains tax rate from 6 April 2008 will substantially increase tax on sales of commercial property for almost all non-corporate investors.

The change will prompt some investors to try to sell up before 6 April to minimise tax. But you should consider the commercial aspects of your present investment and any alternatives before you rush into a sale.

Alternatively you may be able to realise your gains to date by transferring the property to a company you control or some other entity, but there are drawbacks to such a strategy.

Up to 5 April 2008, if you let commercial property, you may be able to pay capital gains tax at a rate of just 10% or less when you sell it – as long as the property qualifies as a business asset for capital gains tax taper relief purposes. There are several qualifying conditions of which you should be aware.

Capital gains tax effectively has a two-tier structure at present, which means that gains on business assets are treated far more favourably than gains on other assets. If you sell a business asset, taper relief reduces your chargeable gain by 50% if you have held the asset for at least one year, and by 75% if you have owned it for more than two years – and that is before deducting your £9,200 annual exemption. On non-business assets, taper relief is also given, but it is much less generous and only reduces the chargeable gain by 5% after three years of ownership, and then by another 5% for each further year up to a maximum 40% relief after ten years. So for non-business assets that qualify for maximum taper relief, the effective maximum rate of tax on the gain is 24% (60% of the gain at a tax rate of 40%).

Whether a commercially let property is a business asset or not depends on the tenant. The property will qualify if the tenant is a sole trader, a trading partnership or an unlisted trading company. Companies listed on the stock exchange and most other tenants do not qualify.

That is the easy bit. The complication is that the taper relief rules have changed since the relief was introduced on 6 April 1998. For the first two years, a property could not qualify as a business asset if the owner let it to an unconnected business. From 6 April 2000, letting to any unlisted trading company qualified, but only from 6 April 2004 did the present rules come into effect.

To calculate taper relief you have to look at the use of the property in the period of ownership since 6 April 1998. Where the business status of the property has changed during that period, or if different parts of the property have different status, it is necessary to calculate taper relief separately for the business part and for the non-business part.

We can carry out these calculations for you and compare the potential tax liabilities on a sale up to 5 April 2008 and thereafter, as well as advise you on what else you should take into account in deciding whether to keep or sell your investment.

What's New in an LPA?

A new legal regime came into effect on 1 October which is intended to give greater protection to elderly people than the enduring power of attorney (EPA) that it replaces.

Like an EPA, a lasting power of attorney (LPA) allows a person – the donor – to appoint a relative, friend or anyone else they trust to manage their affairs should they become incapable of doing so themselves. But there are many differences between the old and new systems.

LPAs come in two forms.
The first, which is entirely new, covers decisions about health, welfare and housing. The second deals with property and money, and is similar to an EPA. The donor can appoint one or more different attorneys for these purposes, and can also specify any restrictions or requirements.

Another new feature is that an LPA is only valid once it is registered with the Public Guardianship Office. Registration will require a signed certificate from a reputable person. This confirms that the donor understood the purpose and scope of the LPA and that there was no fraud or pressure on the donor, who must therefore be mentally capable when making an LPA.

In addition, the donor must nominate at least one person, other than the provider of the certificate, whom the Public Guardianship Office will notify when the LPA is registered, or a second certificate must be provided, which should be signed by a different reputable person. The need for two people to be involved, apart from the attorney, is intended to safeguard the donor.

Once it has been registered, an LPA starts to operate when the donor loses mental capacity. However, a donor can also grant an LPA over their financial affairs (but not their personal welfare) that takes effect while the donor still has capacity.

Clearly the right choice of attorney is important and it is often best to appoint joint attorneys. Although any attorney must by law act in the interests of the donor, not everyone is equally up to the task. The ideal time to prepare LPAs is in conjunction with writing or reviewing your will. And they are not just for older people – even a young person might suffer a serious injury.

The new LPA regime covers England and Wales. Similar powers have existed in Scotland since 2 April 2001 in the form of the continuing power of attorney and the welfare power of attorney. Northern Ireland retains the EPA regime.

business MATTERS

Taking Leave is on the Up

Employees' minimum holiday entitlement is set to increase to 28 days (5.6 weeks) – including entitlement to bank holidays – on a phased basis over the next two years, under the Working Time (Amendment) Regulations 2007.

Since 1998, full-time workers have been given the right to a minimum of 20 days (four weeks) leave a year, although employers could include the eight bank holidays within this figure.

The change is taking place in two phases. From 1 October 2007, the statutory minimum annual holiday entitlement for full-time workers will rise from 20 days to 24 days (4.8 weeks). Then from 1 April 2009, a second increase will bring the entitlement up to 28 days.

The rules also apply to employees working part-time, shifts and term-time only – with leave apportioned on a pro-rata basis, as previously. The increase between October 2007 and April 2009 will be calculated proportionally, depending on when a leave year starts. So, for example, if a leave year starts in April and an employee works five days a week, then their entitlement will increase by two days from October 2007 to March 2008.

Some employers already provide generous contractual holidays that exceed the new minimum, and they will not be affected. The changes only impact on employers who do not offer workers an annual leave entitlement of at least 28 days – pro-rata for those working part-time. In reality, this legislation will have little impact on employers already offering 20 days annual leave in addition to UK bank holidays.

As the new regulations benefit employees, this does not amount to a change in the terms of their employment and there will be no need to reissue contracts to staff. But where it means an increase in holidays, employers will have to inform staff in writing, for example, by letter or by a statement on the pay slip. Templates for informing staff of their entitlement are available from the Department for Business, Enterprise and Regulatory Reform website at: www.dti.gov.uk/employment/holidays/page41004.html

An employer is not allowed to replace an employee's annual leave by making a payment in lieu except on termination of employment. However, as a temporary measure, to help employers make the transition to the new arrangements, between 1 October 2007 and 1 April 2009, employers can pay in lieu of the extra four days (0.8 week).

Surviving a Disaster

Businesses are far more likely to suffer from extreme weather, such as flooding, rather than fire, according to recent research published by the Chartered Management Institute. The most common causes of business disruption are loss of computers/IT and key staff.

The fact that firms usually place more emphasis on planning to survive a fire than a flood suggests that many businesses and other organisations need to revise their priorities, especially with the onset of global climate change, which has been brought into sharp focus by this summer's unseasonal downpours.

Some firms are particularly vulnerable to potential losses from flooding and other natural disasters depending on their geographical location and type of business. But there are many other risks that affect the security of all kinds of organisations. It makes sense to review all the possible threats to continuity, from the integrity of the supply chain to a prolonged loss of power or water. Whether a business survives an unplanned event will largely depend on the quality of its forward planning.

Research from the British Chambers of Commerce suggests that 80% of businesses without a plan fold in the aftermath of a disaster. A report on climate change commissioned by AXA last year indicated that 90% of small businesses are under-insured – with one in three without business interruption cover to pay their wages and other costs.

The evidence clearly shows that the key to survival, once disaster strikes, is a business continuity plan that is regularly updated and rehearsed. It is essential to keep a copy of the plan away from the site. The plan should be simple but focused, with the business risks clearly prioritised and analysed according to their likelihood and potential impact. A typical business continuity plan includes:

- A planned sequence of actions to keep operations going and to recover fully.
- An outline of the role of individual managers and employees for each scenario.
- Details of the off-site IT data back-up and recovery services.
- A list of the key contacts including insurers and utility providers.

Businesses can plan to reduce the risks, but insurance is still important as the 'long-stop'. Business interruption insurance can help a business recoup financial losses from having to cease operations unexpectedly for a few weeks or months.

Key person insurance can protect against the financial consequences of losing key members of staff as a result of death or serious illness. If it is worth insuring assets like buildings, stock and equipment, it is probably worth insuring the most important assets of the business – the key people.

This newsletter is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking any action on the basis of the contents of this publication. The newsletter represents our understanding of law and HM Revenue & Customs practice as at September 2007.