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Tax Briefing

Winter 08/09

Welcome



Jay Sanghrajka

...to the winter edition of our tax briefing. As I write this introduction I can see heavy snow falling outside my window. This is a graphic reflection of where the UK economy is at the moment. In the last edition I mentioned that I hoped that the recession would be both short and shallow yet the fear was that it would be both deeper and longer. Indications are now that the latter will

be the case. The Bank of England has dropped the bank base rate by another ½% to 1%. How much lower can it go?

In this edition we include a series of articles that deal with tax and the recession. As you will see from each of these that the current economic circumstances will provide a number of unique tax planning opportunities.

Please feel free to contact one of our tax specialists for an initial meeting to discuss these and other tax planning opportunities or any of the other articles.

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Every Cloud has a Silver Lining



Alan Thomson

As with every set of circumstances there are unique tax opportunities and the recession is no different.

In this article we will look at what tax planning private individuals and owners of businesses should consider in anticipation of the future recovery which will inevitably happen as sure as day will follow night.

Capital Losses

It is worth noting that capital losses that are crystallised in the current tax year can if not utilised against current year gains be carried forward indefinitely to future years.

Therefore in the current climate with deflated asset values several opportunities should be considered.

If an individual taxpayer has already made capital gains during the current 2008/09 tax year it is worth looking at the remaining share portfolio to establish if losses can be crystallised to offset these gains.

Even if there are not gains in the current tax year you might still wish to "fix" the loss now even if you wish to retain the asset. There would be an advantage in doing this by 5 April 2009 despite the fact that the initial disposal will reduce the base cost for any subsequent disposal, if the

losses are likely to be able to be used sooner than the eventual disposal, there may be a cash flow benefit. There are a number of ways that would enable you to dispose of the asset while effectively retaining the benefit of ownership. These include a sale by the individual and a buy back by the spouse. The individual could also consider a sale and buy back outside the 30 day anti-avoidance period.

Another thing to consider if the individual is holding shares that have negligible value an election should be considered to establish the loss.

Valuations

Lower asset valuations may provide the opportunity to consider restructuring of family assets in order to create more tax effective structures.

Periods of deflated values give a unique opportunity to look at providing for the family in the longer term whilst at the same time achieve an Inheritance Tax ("IHT") benefit. For example a gift of an asset to another individual with a much lower value will still obtain the same IHT relief as a Potentially Exempt Transfer with no tax charge provided the donor survives 7 years yet with a much

reduced capital gains tax ("CGT") liability because of the reduction in value.

In terms of further tax planning it should be noted that where asset values are low the nil rate IHT band of £312,000 will go much further.

Also where individuals have wealth locked into shares in a family company it may be an opportunity to extract value such as land and property from the company while low values can be negotiated.

Cash is King

It is worth remembering that income tax payments made on account for the 2008/09 tax year are based on the previous years results unless an election is made to reduce payments. Where in the current economic climate there is likely to be a substantial fall in current year profits the individual should consider electing to reduce payments on account to improve cash flow.

If you would like to discuss these or other possible tax planning opportunities in a recession please contact the following

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Cash generating loss reliefs available to property companies



Steven Levine

The Government has introduced a number of corporation tax reliefs that enable companies to cash-in on their tax losses. Any method of generating cash during the current credit crunch is likely to be very valuable and these particular reliefs and opportunities open to companies in the property sector are set out below.

1. Research and Development Tax Reliefs

A common mistake with Research and Development Tax Reliefs is that it is widely considered that these are only available for pharmaceutical companies or other similar companies at the forefront of medical research. We have made many claims for companies in manufacturing and engineering, some of whom are within the property sector.

Opportunities include companies involved in developing modern methods of construction, solutions for sustainability and those products that deliver scientific or technological improvements over previously available versions. This is an incredibly wide opportunity.

Once the opportunity has been identified, the costs qualifying for relief are subject to a 75% uplift, then to the extent these uplifted costs enhance or create a tax loss, these tax losses can be exchanged for a cash credit equivalent to 14% of the cost including uplift – subject to total PAYE and NIC paid during the accounting period.

Example 1: A loss-making company incurring £100,000 of qualifying R&D expenditure would aim to trigger a cash refund of £24,500 – being £175,000 x 14%.

There are many conditions covering issues such as the date the costs were incurred, the number of

employees, the size of the company, the number and size of group companies, the type of any subsidies received, whether it is a going concern and the size of the project. Each claim will depend on its own particular circumstances.

2. Enhanced Capital Allowances

Enhanced Capital Allowances enable the entire cost of a capital asset to be deducted against profits. The types of capital asset that can qualify for this are very specific and can broadly be described as “eco- friendly”.

These assets cover a number of categories including amongst others boiler equipment, motors and drives, heating systems, refrigeration systems, water delivery and lighting. They are listed by manufacturer and model on the Enhanced Capital Allowances website and can be accessed using www.eca.gov.uk.

Since 1 April 2008, where this deduction against profits has created a tax loss, this loss can be exchanged for a cash refund equivalent to 19% of the tax loss.

Any refund is restricted to £250,000 or the amount of PAYE and NIC paid to the Revenue during the accounting year if this is lower. Any cash refund can be clawed back by the Revenue if the capital asset is sold within four years.

Example 2: A loss-making company spending £100,000 on qualifying assets would aim to trigger a £19,000 cash refund.

The major opportunity here is on a property refurbishment involving the installation of “eco- friendly” capital assets although there are also opportunities arising on property refits. New properties benefitting from solar power and other ‘green’ energy initiatives should also benefit.

A further opportunity arises to companies carrying out refurbishments that will be able to identify these assets for their clients at the quoting stage so that they can differentiate their company from the competition and add real value to their product.

2. Land Remediation Relief

Even though Land Remediation Reliefs have now been around for about seven years, it is still surprising how often these are omitted from tax returns and never claimed.

Essentially where companies – usually involved in property investment or property development – incur costs on removing, containing or treating contaminated land, the qualifying cost is uplifted by 50% for tax purposes. These qualifying costs should include related professional fees and preliminaries as well as the actual costs themselves.

Examples of contaminated land include asbestos, oils and heavy metals. The only condition is that the company must not be the original polluter.

This additional uplift of 50% can either reduce taxable profits or enhance tax losses. To the extent that there are tax losses, the company can surrender the uplifted costs for cash at a rate equivalent to 16% of the combined costs of land remediation and the 50% uplift.

Example 3: A loss-making company spending £100,000 removing asbestos from a factory would aim to trigger a cash refund of £24,000 – being £150,000 x 16%.

Opportunities include property developers or investors who may be building on, converting or renovating old properties, industrial sites or garages. There are also



opportunities for trading companies who are renovating newly acquired premises (whether industrial or not). Contractual terms for the sale of property can be crucial as vendors may be able to trigger additional proceeds through recognising potential claims.

Conclusion

Directors of companies who consider that they may qualify for any of these should seek professional advice as soon as possible. There are strict time limits for backdating claims and delays can be costly.

For completeness, it should be mentioned that non-corporation tax reliefs may also be available in certain

circumstances including Stamp Duty Land Tax, VAT and Landfill Tax.

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Taxation of dividends and foreign company profits



Jay Sanghrajka

Since our last update on this subject, as predicted in the Pre Budget Report on 24 November, HMRC and the Treasury issued draft legislation with explanatory notes on 9 December 2008. A further round of consultation is under way, to be completed by 3 March 2009. It is intended that legislation will then be introduced, mainly through the Finance Bill 2009, to implement the changes with effect from an appointed day that could be as early as 1 April 2009, but may be later on in 2009.

Although the draft legislation is bound to change over the next few months, what has been issued does give a better indication of the reforms that are now to be expected and there are some important planning points to consider.

Company dividends

In the draft legislation, dividends paid by foreign companies from the appointed day will generally be exempt from tax if received by "large or medium" sized UK companies. Dividends will remain taxable in certain circumstances including where:

- they fall within a targeted anti-avoidance rule covering five prescribed types of scheme,
- they are tax-deductible in the country of payment,
- they are taxable under other taxing

provisions that take precedence, e.g. trading profits, loan relationships or property business,

- they are Acceptable Distribution Policy (ADP) dividends from a Controlled Foreign Company (CFC).

To maintain a non-discriminatory approach, it is intended that this new approach will apply equally to dividends received by one UK company from another. Therefore dividends within a UK group will no longer be tax-free if they fall within the targeted anti-avoidance rule.

Dividends from foreign companies that are received by small companies will remain taxable where the recipient controls 10% or more of the payer.

If a foreign dividend is taxable under the new rules, a simplified double tax relief system will apply but the onshore pooling rules will be abolished. This means that any excess double tax relief that has accumulated will be wasted.

Under some double tax agreements, dividends are taxable in the source country unless they are taxable in the country of the recipient. It is recognised that in these circumstances the new exemption in the UK will result in a new withholding tax liability in the source country, and consultation has been specifically requested on this.

In a number of situations, these changes could increase the tax cost

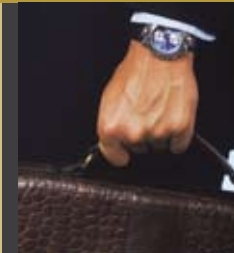
of a dividend and early distribution under existing rules should be considered.

Controlled Foreign Company (CFC) changes

Whilst the other elements of this tax reform have been accelerated, the general reform of the CFC regime that is awaited is going to be subject to further consultation and may not come into the tax legislation until 2011.

In the meantime, as a consequence of the new exemption of tax for dividends, the ADP exemption from the CFC charge is to be abolished with effect from the appointed day. Accounting periods of the CFC that straddle the appointed day will be split into two separate accounting periods on a just and reasonable basis with ADP exemption available to the earlier one.

One other change to the CFC rules is expected to come in from the appointed day. This is the abolition of special rules that provide exemption for some holding companies that derive income from "exempt activities". This exemption has been available where at least 90% of the gross income of the CFC holding company derives wholly from exempt activities. For a holding company that did not meet this requirement for its last accounting period to end before the appointed day, the abolition of



the holding company exemption will apply from the appointed day, with the straddling accounting period being split as for ADP purposes.

For a CFC holding company that meets this requirement for its last accounting period to end before the appointed day, the current exemption may apply for a further two years, but there will be a further condition relating to the quantum of non-exempt income. The purpose of this transitional relief is to allow established groups with CFC sub-groups some time to restructure.

Movements of capital

The draft legislation removes the long-standing requirement for

treasury consent prior to movement of capital outside the UK. In its place will be a quarterly post-transaction reporting requirement for specified transactions or events in excess of £100m.

Loan relationships and the unallowable purpose test

The draft legislation includes an extension to the existing rules that disallow loan relationship debits and derivative contract expenses if they have a tax avoidance purpose. The new provisions would extend this disallowance to circumstances where the loan relationship or derivative contract is part of an arrangement that has a tax avoidance purpose.

General

These significant changes in the draft legislation will mainly affect groups that are headquartered in the UK. Any groups affected could benefit from good tax advice so as to maximise the available reliefs under current rules and into the transition, as well as considering whether any restructuring would be beneficial for the future.

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The Worldwide debt cap



John Owen

Whereas the exemption of most dividends from tax will be a cost to the Treasury to the benefit mainly of UK companies with international interests, the other main provision in the draft legislation is intended to raise revenue for the Treasury, at the expense mainly of overseas groups that have invested into the UK. This is the proposal to restrict relief for interest paid in a mechanical fashion by reference to a worldwide debt cap.

This draft legislation is also liable to further development and is intended to apply to periods of account that end after a date to be appointed. Where a period of account straddles the appointed day the new rules will only apply to the element that falls on or after that date.

In summary, whilst the draft legislation will have no effect on tax relief for the costs of external borrowings by UK companies, it will restrict tax relief for interest payable on intra-group borrowing to the extent that this exceeds the external

interest paid by the rest of the worldwide group. These rules will apply to all world wide groups that are "large".

The restriction will operate by comparing the "tested amount" of finance costs with the "available amount" and disallowing the excess. The "tested amount" will be the total intra-group finance costs in the UK, taken from the corporation tax computations. The "tested amount" will include the finance costs implicit in finance leases of plant and machinery and in debt factoring transactions.

The "available amount" will be the non-UK external finance costs of the worldwide group, taken from the consolidated accounts of the worldwide group and as currently drafted these must be prepared under, or adjusted to comply with IFRS. This may not recognise finance costs on the same basis as the tested amount.

To the extent that any disallowed interest would otherwise fall to be

subject to UK corporation tax in the company by which it is receivable, the corresponding income will not be taxable.

So as to avoid any charge of discrimination, these rules will apply to domestic groups as well as international ones. For instance, in a management buyout of a UK company by a UK Newco the "available amount" will usually be zero and therefore any intra group interest will be ignored for tax purposes. This could have the effect of stranding tax losses in Newco rather than the trading subsidiary. This is a specific point for consultation.

As these rules will fall to be dealt with properly in tax returns prepared under self assessment, they seem likely to add significantly to the burden of tax compliance. This is because the UK company will have to have regard to the external finance costs of the worldwide group. The authorities are therefore interested in recommendations for a gateway test



to enable groups that can provide reasonable certainty that the cap would not lead to a disallowance to be able to demonstrate this in a simplified manner.

Comments have also been invited specifically to deal fairly with external

borrowing that are not in sterling and may be of a substantially different rate of interest to that being charged to the UK company on its sterling debt, and also with situations where cash balances are not economically available to the group.

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Use of Share Schemes in a Recession



Graham Goodbody

As the UK goes deeper into recession and companies shed staff, it is worth considering the place that shares schemes may have in the remuneration package in these changing circumstances.

Firstly, it should be noted that the Share Incentive Plan, which covers all employees, is unlikely to have any value in the matters discussed below and while the Company Share Option Plan can be targeted on selected individuals, it lacks the flexibility that is likely to prove necessary. The Enterprise Management Incentives ("EMI") scheme is the scheme that should be considered for the current economic climate.

To recap on the details of EMI, this was a scheme that was introduced in 2000 following Government discussions with the professions regarding what sort of share scheme would provide employees with the greatest incentive. That was the time of the "Dot Com" boom when innovative companies were being set up with virtually no money, but lots of hope and potential. Selected employees of those companies were provided with EMI options as this could be very valuable if the company flourished, but cost nothing to the company or employee if the company failed.

EMI allows the granting of options over shares having a market value

of up to £120,000 at the date of grant. There are very few conditions in the legislation that have to be fulfilled before the options are valid EMI options. The shares must be ordinary shares in a trading company, the employee being granted them must not have more than 30% of the equity in the company, the employee must be a full time employee or work for the company for at least 75% of his working time if he is part-time. Beyond this, it is largely up to the company and employee what conditions apply.

Provided the options are valid EMI options, there is no income tax charge if the employee pays at least the market value of the shares at the date of grant when he exercises. If he pays less than that market value, he is subject to income tax (as employment income) on the excess of market value over the exercise price. After this, any growth in value is subject to capital gains tax normally at 18% on the excess over the annual exemption (currently £9,600).

How does this help in a recession? Employers need to look to the future as the recession will not last forever and at the end of the recession they will need to have retained the services of key employees. Cash is obviously tight in a recession and therefore a non-cash solution to

staff retention can be attractive. If the company does not survive the recession, the options will lapse and the employees have no tax liability or a requirement to acquire the shares. If the company survives and prospers, the employee will be able to benefit by exercising his options and acquiring shares that will have increased in value. It also demonstrates the company's commitment to the employees as the intention to retain their services is evidenced by the granting of options.

In setting up a scheme now, it is possible to negotiate very low market values with HM Revenue & Customs, as valuations are usually based upon quoted companies' price earnings ratios which are particularly low at present due to the state of the stock market. We are also finding that companies are keen to include performance targets in the agreements that have to be achieved before the options can be exercised. This guarantees that the shares themselves are only available to employees when they have fulfilled their part of the bargain.

If you would like to examine the possibilities of setting up an EMI share option scheme please contact:

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There is no such thing as a tax free lunch; or is there?



Mark Baycroft

The tax treatment of subsistence expenditure incurred by the employed and self-employed while on visits to clients has always been unclear, and in some cases there appears to have been discrimination between employees and the self-employed.

For example, an employee on a day long visit to a client could claim a tax deduction for the cost of travelling to see the client and the cost of the lunch purchased on route. A self-employed person could claim a tax deduction for the travel, but not for the lunch.

The position appears to have been clearer in respect of overnight accommodation and associated subsistence, where both the employed and the self-employed could claim a deduction for subsistence associated with the overnight stay, for example an evening meal in an hotel, although in the case of the self-employed this was on an extra statutory concessional basis.

HM Revenue & Customs have recently announced a proposal to put some extra statutory concessions on a statutory basis, and the proposed wording of the legislation on subsistence expenditure may make it possible for the self-employed to claim tax relief for lunches.

The proposed wording of the legislation will allow the self-employed trader to claim a deduction for the reasonable cost of food and drink consumed at a place to which the trader has travelled for business, or while travelling to that place, if the following conditions are met:

Condition A, deduction would be allowed for the cost of travelling to that location, whether the cost is borne by the trader or their client; and
The trader is to a location which the trader only visits occasionally and there is no normal pattern of travel to that location/area, or the trade is by its nature itinerant, for example a commercial traveller.

Condition B will deny a tax deduction

for traders who establish a regular pattern of visiting certain clients or areas unless the trade is by its nature itinerant; any such regular pattern should therefore be avoided.

Assuming the proposed legislation becomes law, self-employed traders will soon be able to enjoy a tax free lunch whilst travelling to meet a client, or at their destination provided they do not invite their client to join them and be "entertained".

As with all tax deductions, a key point will be to keep records to separately identify such expenditure. It is recommended that expenditure by both the self-employed and by employees on "business travel and subsistence", including food and drink that meets the conditions above, is recorded separately from "business entertaining" in the accounting records.

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This briefing has been written for the general interest of our clients and contacts. It is essential to take advice on specific issues. We believe that the facts are correct as at February 2009 but there may be certain errors or omissions for which we cannot be held responsible.

The opinions expressed in guest articles are those of the respective contributors and their firms. We believe that these should be of interest to our clients and contacts but the articles do not necessarily represent the views of Chantrey Vellacott DFK LLP.

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