

## NIIFA IS PLEASED TO WELCOME FOUR NEW MEMBERS

- |                 |  |                    |
|-----------------|--|--------------------|
| David Adamson   | • Adamson Forensic Accounting Ltd            | • Edinburgh        |
| Shaun Walbridge | • SW Forensic Accounting Ltd                 | • Plymouth         |
| Martin Jackson  | • Jackson Calvert                            | • Sutton Coldfield |
| John Kenny      | • Providence Forensic Accounting Experts Ltd | • Wicklow          |

## NIIFA BBC CALL ON NIFA'S EXPERTISE IN FAREPAK COLLAPSE

The BBC called on NIFA member David Winch for comment on the Farepak collapse in an interview that was broadcast on BBC1 on the 4th December 2006. The interview was also documented on the BBC's news website. <http://news.bbc.co.uk>

## NIIFA Tax and divorce

Too often the accounting expert is appointed too late to make a difference to the financial settlement. Too often the accountant is asked merely to "value the spouse's shares in ABC Limited" and only later asked, as an afterthought, how to extract funds from the company. With a bit more up-front involvement, the accountant can help to ensure that the divorcing couple safeguard the marital assets for themselves, with the legal minimum amount of tax going to the Treasury.

Advance warning is needed if tax avoidance is to be undertaken professionally and successfully. A company buy-back of its own shares takes time to complete – there's the need for clearance under section 225 ICTA 1988 from HM Revenue and Customs and, of course, legal assistance to ensure the buy back is properly documented as well as accounting assistance to make sure it is tax efficient and is properly accounted for.

### Before separation

The best tax plan is to pay no tax whatsoever while complying with the law. Transfers between husband and wife are treated as being on a no-gain-no-loss basis for Capital Gains Tax. This also applies to a sale of shares from one spouse to another. So, if it is possible, shares owned by one spouse can be sold to the other without tax consequences provided it is done within the fiscal year when separation takes place. This requires a large degree of collaboration between, and foresight by, the parting couple.

### Avoiding tax by gifting assets

Tax planners always punch the air when HM Revenue and Customs lose and that happened after the case of *G -v- G [2002] EWHC 1339*. Prior to this case the Revenue had always argued that post separation, any transfer of assets from one former spouse to another, did not qualify for gift hold-over relief. Hold over relief means that any capital gain arising on the transfer is deferred (held over) until the transferee disposes of the asset in question. The Revenue argued that the transferee had surrendered rights in return for the transfer and that those rights were chargeable to Capital Gains Tax.

Coleridge J. was quite dismissive of the Revenue's attempt to interpret the law in its own favour and ruled that where the court directed one divorcing party to transfer assets to the other, then that was the exercise by the court of its independent statutory jurisdiction and was NOT the surrender of rights by the donee. **HMRC 0 Common sense 1!!**



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So, make sure that you get an order for ancillary relief under the Matrimonial Causes Act 1973 which transfers assets from one spouse to another or, alternatively, an order ratifying an agreement reached by the divorcing couple as to the transfer of assets.

### Trusts and divorce

Expert tax advice should be sought if a spouse has a life interest in a trust. From April 2008, if a court orders that a spouse who has an existing interest in a trust should appoint an interest to their former spouse, then that will constitute a chargeable transfer and the transferor will not be entitled to any relief under s10 IHTA 1984. This also means that the interest transferred will become subject to the 10 year periodic charge.

Trustees should consider an absolute advance of capital from the existing trust. This would be covered by the spouse exemption only if the divorce was not absolute.

If a court orders a spouse to settle assets which they own absolutely into a new trust for their separated spouse, then no spouse exemption will be available and the transfer will be chargeable.

## **NIFA** Extracting funds in a tax efficient manner

So how can we get funds from the company in a tax efficient manner?

The simplest route is if the spouse is a director and has lent money to the company. His / her Director's Loan Account ("DLA" in accounting jargon) will be in credit. He/she can draw funds from the company up to the amount standing to the credit of the DLA without tax consequences. If the company does not have sufficient funds, it may be possible for the company to borrow funds to enable it to repay the DLA.

### Earnings from employment

Any funds leaving a company for the benefit of an employee, director (other than a repayment of a loan made to the company) or shareholder are subject to tax. Thus, paying a director a higher salary will result in the director suffering more income tax (probably at 40%) and more National Insurance (at 1%) and will result in the company paying 12.8% National Insurance. Apart from the tax cost, there is the added complication that other directors may not agree to one of the board getting an increase, whilst others do not.

### Dividends

If the spouse is a shareholder, then a dividend could be declared. National Insurance is not charged on dividends, so taking a dividend rather than a salary will save 12.8%. Furthermore, dividends received by higher rate tax payers are not taxed at 40% as are earnings but at 25% of the net amount received or 22.5% of the amount of the gross dividend. Once again, resistance may well be encountered from other shareholders, especially if they are asked to waive their entitlement to a dividend. It is also well worth checking that the company has sufficient retained profits and cash to enable it to pay a dividend.

### Drawings

If the business is not a limited company – a partnership or sole trader for example – then an increase in drawings could be made by the spouse making the settlement. Increasing drawings in a sole trader business is not a problem, provided there are funds in the bank account, but in a partnership, it may not be possible without changing the partnership agreement and could lead to heated discussions! Drawings are not assessed to tax in unincorporated businesses – it is the profits that are assessed to tax.

### Loans

If the unincorporated business can borrow money, then it could be lent to the partner / proprietor. However care is needed to ensure that the Revenue do not restrict the deduction of interest against taxable profits on the grounds that the borrowing is not wholly for the purposes of the trade.

Borrowings from a company by a spouse who is a director or shareholder of that company are not usually advisable. Companies are generally prohibited by section 330 Companies Act 1985 from making loans to directors (unless the lending of money is part of the company's normal activities). Furthermore, the Revenue will assess the company under section 419 ICTA 1988 at the rate of 25% on any amounts owed to the company by the director.

### **Sale of assets and sale and leaseback**

Sometimes a business may have assets that are surplus to its requirements – plant and machinery that is no longer fully utilised or land that could be sold off for development. Selling assets or selling them and leasing them back will generate cash. It may also create a Capital Gain. Capital gains in a company can be offset against trading losses made in the same accounting period. So, it may be worthwhile looking at how a loss might be created. Increasing remuneration is one way, but not very tax efficient. Increasing contributions to a pension fund (subject to the statutory restrictions) is more efficient.

### **Pensions**

In the case of a company in which the husband and wife are each directors and 50% shareholders, tax efficiency could be gained if the company made a contribution of up to £215,000 each to a company pension/SSAS/SIPP. The company gets corporation tax relief on the contribution - but only if it can show that the contributions are for the benefit of the business. A pension splitting order could then be used to give the wife up to 100% of the benefit. If she is over 50 she can draw 25% in cash and take an income from the balance.

Care needs to be exercised in this area, particularly if a 50% shareholder / director is taking only the minimum wage by way of salary and the balance of his remuneration by dividend. In such circumstances a challenge from the Inland Revenue can be expected and it would be better to ensure that the director / shareholder is paid an appropriate salary, commensurate with a contribution of £215,000.

### **More aggressive tax avoidance**

For those of a more combative disposition, the use of Employee Benefit Trusts may be attractive. Despite the government's attempt to block such mechanisms following the well publicised divorce of Ray Parlour, the Arsenal mid-fielder, there are still structures that exploit loopholes in the new legislation in order to reduce taxable profits in the settlor company whilst avoiding income tax and National Insurance for the beneficiary. Such mechanisms have been used in the past to hide assets when a divorce looms on the horizon.

A combative disposition is required because the Revenue are determined to attack such structures. They succeeded in the Dextra case (although the appeal has yet to be heard) but the result was that new variants of EBTs have been developed and are operating successfully – until the Revenue mount a successful challenge. It's a case of cat and mouse – the Revenue closes one mechanism and the tax planners find another.

### **Company buy-back of shares**

Finally, a popular means of extracting funds tax efficiently is by way of a company buy-in of its own shares. Rather than the spouse having to find the cash to pay for the other spouse's shares, the company buys back those shares from the departing spouse. However, this will not be appropriate where one of the divorcing spouses is actively engaged in the business and plans so to continue because the selling shareholder must sever all links with the company – see below.

If the shares have been held for two years and if the company is a private trading company, then Business Asset Taper Relief will be available to the vending shareholder, reducing his / her tax to 10% of the gain.

A company must satisfy the conditions set down in the Companies Act 1985:

- *The company must have the power in its Articles of Association to purchase its own shares;*
- *The shares acquired are immediately cancelled;*
- *The contract for purchase must be available at the EGM and approved by special resolution and kept for 10 years at the registered office;*
- *At least one irredeemable share must be held after the buy back;*
- *Payment must be made immediately and cannot be deferred;*
- *Shares purchased are usually acquired out of distributable profits but can be acquired out of capital if all profits are first used - there are other quite demanding conditions attaching to a purchase out of capital;*
- *Company's capital base must be preserved by establishing a non-distributable capital redemption reserve equal to the nominal value of shares acquired.*

If the vendor is to take advantage of the 10% tax rate, then the buy back must qualify as a capital disposal. There are several conditions to be met if Capital Gains Tax is to apply at 10% (section 219 ICTA 1988):

- *The vendor must be resident and ordinarily resident in the UK for the tax year in which the buy back takes place;*
- *The vendor must have owned the shares for at least 5 years - watch out for recent bonus issues or gifts of shares received which the vendor may have forgotten about!*
- *The buy back must be for the benefit of the company's trade ;*
- *The purpose must not be the avoidance of tax;*
- *The company must be an unquoted trading company;*
- *The vendor must not be connected with the company after the buy back - cannot remain as a director;*
- *The vendor must reduce his / her interest in the shares by at least 25% - check the calculations because the shares bought in by the company are cancelled and the calculation of the reduction needs to take account of the lower number of shares in issue.*

Of course, if the capital treatment is not possible, then the buy back is treated as a distribution and taxed as a dividend on the vendor – 25% of the net dividend received.

Most solicitors will have a commercial department which is skilled and experienced in the buy back of company shares and it is important to get the Articles, resolutions, minutes and contract for sale properly drafted.

### **Group reorganisations**

In cases in which both husband and wife are shareholders in more substantial family companies and each wish to retain an interest in part of the business or assets, then a tax efficient split can sometimes be achieved using the Demerger provisions of Section 110 of the Insolvency Act 1986.

For example if a company has a trading business and also owns investment properties, or has two separate trades, then each spouse can receive their own company into which can be put those assets or trades in which they wish to retain an interest. Such schemes tend to be expensive but, for larger cases, the tax savings can be considerable.

In conclusion, tax will inevitably raise its ugly head in divorce proceedings and the sooner we can get a fix on it, the sooner and better able we will be at avoiding it in whole or in part. That is precisely where the expert accountant can help. All NIFA members are willing to discuss tax planning opportunities, before appointment as expert, to enable the couple's solicitors to decide whether there are opportunities for saving tax.

## NIFA Accredited Forensic Accountants

Roger Isaacs, <i>Milsted Langdon, Bristol, Taunton, Yeovil</i> 0117 945 2500	David Muggridge, <i>Dendy Neville, Maidstone</i> 01622 686 441
Jeanette Hume, <i>Peters Elworthy &amp; Moore, Cambridge</i> 01223 728 222	Brian Spence, <i>Montpelier, Manchester</i> 0161 831 6453
Chris Hatcher, <i>Watts Gregory, Cardiff</i> 029 2054 6600	Clive Adkins, <i>Kilby Fox, Northampton</i> 01604 662 670
Michael Woof, <i>Little &amp; Company, Gloucester, Bristol</i> 01452 308 966	Peter Smith, <i>Quantis, Northumberland</i> 01670 511 999
David Winch, <i>Accounting Evidence Ltd, Cumbria</i> 01229 716651	Martin Berry, <i>Hobsons, Nottingham</i> 0115 962 1590
David Adamson, <i>Adamson Forensic Accounting Ltd, Edinburgh</i> 0131 228 8319	Shaun Walbridge, <i>SW Forensic Accounting Ltd, Plymouth</i> 01752 202090
Raymond Davidson, <i>Bartfields, Leeds</i> 0113 244 9051	Philip Allsop, <i>Barber Harrison &amp; Platt, Sheffield</i> 0114 266 7171
Clive Haslock, <i>Haslocks, London (E1W)</i> 0207 265 0606	Martin Jackson, <i>Jackson Calvert, Sutton Coldfield</i> 0121 355 0404
Henry Freedman, <i>Grunberg &amp; Co. London (NW11)</i> 0208 458 0083	John Kenny, <i>Providence Forensic Accounting Experts Ltd, Wicklow</i> +353 (0)404 61033

Telephone: 0845 609 6091 E-mail: [nifa@nifa.co.uk](mailto:nifa@nifa.co.uk) Website: [www.nifa.co.uk](http://www.nifa.co.uk)