LAW ANGELS

TAXATION LAW

SQE 1 PREP

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PREFACE

Welcome to *Taxation for Business Lawyers: A Solicitor's Guide to the SQE*. This book was born from a simple but powerful conviction: that a confident grasp of tax law is not a specialist luxury, but a core component of competent and strategic legal advice.

The journey to becoming a solicitor is demanding, and the Solicitors Qualifying Examination (SQE) presents a unique challenge, requiring a deep and practical understanding of how law operates in the real world. Tax permeates almost every commercial and personal transaction you will encounter as a lawyer. Whether you are structuring a startup, negotiating a merger, drafting a partnership agreement, or advising on estate planning, the tax consequences will often be the defining factor in your client's decision. To ignore tax is to provide incomplete, and potentially negligent, advice.

This textbook is designed with you, the future solicitor, in mind. Our mission at Law Angels is to demystify the UK tax system, transforming it from a source of anxiety into a toolkit for opportunity. We have structured this guide to build your knowledge from the ground up, starting with the fundamental principles and progressing to their application in complex business scenarios. Each chapter is filled with clear explanations, practical examples, and illustrative case studies that bridge the gap between abstract legislation and the tangible advice you will give to clients.

Our focus is relentlessly practical. We emphasise the solicitor's role as the architect of transactions and the guardian of legal structures, distinguishing it from the accountant's role in computation and compliance. You will find dedicated sections on ethical boundaries, anti-avoidance rules, and the professional duty you owe to your clients and the legal system.

As you work through this guide, you will not only be preparing to succeed in the SQE; you will be laying the foundation for a successful and respected career in law. We hope this book becomes a trusted resource, empowering you to advise your clients with clarity, confidence, and commercial acumen.

Good luck on your journey.

Law Angels

ACKNOWLEDGEMENTS

The development of this textbook was a significant endeavor, and we extend our sincere gratitude to the collective efforts that made this publication possible.

At Law Angels, we are fortunate to be supported by a dedicated team whose commitment to legal education and excellence is the cornerstone of our work. The collaborative spirit, legal expertise, and tireless effort of our entire organization were instrumental in shaping this text from concept to completion.

We also extend our appreciation to the broader legal community. The insightful feedback from our academic and practitioner reviewers greatly enhanced the accuracy and clarity of the material. Their contributions, offered in a spirit of scholarly collaboration, have been invaluable in ensuring this resource meets the rigorous demands of the SQE curriculum.

We are also thankful for the unwavering support from our personal networks, whose understanding provided the foundation that allowed this project to thrive.

It is our privilege at Law Angels to contribute to the education of future solicitors, and we hope this text serves as a reliable guide for the next generation of legal professionals.

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GLOSSARY OF KEY TERMS

A

Accounting Period: The 12-month period for which a company prepares its accounts and calculates its Corporation Tax liability. It is often, but not always, the same as its financial year.

Allowable Expense: A cost incurred "wholly and exclusively" for the purposes of a trade, profession, or vocation, which is deductible when calculating taxable profits.

Annual Investment Allowance (AIA): A capital allowance that permits a business to deduct the full cost of most plant and machinery (up to a specified annual limit) from its profits before tax.

B

Basis Period: The period of trading profits that are assessed to Income Tax for a sole trader or partner for a given tax year.

Business Asset Disposal Relief (BADR): A relief from Capital Gains Tax that applies a 10% tax rate to qualifying gains on the disposal of all or part of a business. Formerly known as Entrepreneurs' Relief.

Business Property Relief (BPR): A relief from Inheritance Tax that can reduce the value of a business or business assets by 50% or 100% when passed on during life or on death.

C

Capital Allowances: Tax deductions for the cost of certain capital assets (e.g., machinery, equipment) purchased for use in a business, acting as the tax substitute for accounting depreciation.

Capital Gains Tax (CGT): A tax on the profit made when you sell, gift, or otherwise dispose of an asset that has increased in value.

Corporation Tax: A tax levied on the worldwide profits of UK-resident companies.

D

Disallowable Expense: A cost that cannot be deducted when calculating taxable profit, even if it has been paid for by the business (e.g., client entertainment, fines).

Domicile: A general law concept referring to the country that a person considers to be their permanent home. It is distinct from residence and is crucial for Inheritance Tax and the taxation of foreign income for non-domiciled individuals.

G

General Anti-Abuse Rule (GAAR): A statutory rule that gives HMRC the power to counteract tax advantages arising from tax arrangements that are deemed "abusive."

H

HM Revenue & Customs (HMRC): The UK government department responsible for the collection of taxes, the payment of some state benefits, and the administration of other regulatory regimes.

I

Income Tax: A tax on an individual's income, including earnings from employment, profits from self-employment, rental income, and savings and dividend income.

Input Tax: The Value Added Tax (VAT) a VAT-registered business pays on its purchases of goods and services.

Inheritance Tax (IHT): A tax on the estate (property, money, and possessions) of someone who has died, and on certain gifts made during an individual's lifetime.

N

Nil-Rate Band (NRB): The threshold below which no Inheritance Tax is payable on an estate. For 2024/25, this is £325,000.

O

Output Tax: The Value Added Tax (VAT) a VAT-registered business charges on its sales of goods and services to its customers.

P

Pay As You Earn (PAYE): HMRC's system for collecting Income Tax and National Insurance Contributions from employees directly from their wages or pension before they are paid.

Personal Allowance: The amount of income an individual can earn each tax year before they start paying Income Tax.

R

Residence: A statutory test based on the number of days spent in the UK, which determines whether an individual is subject to UK tax on their worldwide income and gains.

S

Self-Assessment: A system used by HMRC to collect Income Tax and Capital Gains Tax. Individuals and partners are responsible for completing a tax return to declare their income and calculate the tax due.

Sole Trader: An individual who is the exclusive owner of a business, entitled to all profits but personally liable for all losses. There is no legal distinction between the individual and the business.

T

Tax Avoidance: Using the tax law in a contrived and artificial way to gain a tax advantage that Parliament never intended. It is not illegal but is high-risk and can be counteracted by HMRC.

Tax Evasion: The illegal, deliberate concealment of income or information from HMRC to reduce tax liability. It is a criminal offence.

Tax Planning: The legitimate arrangement of a client's affairs to use tax reliefs, allowances, and incentives in the way they were intended by Parliament.

Tax Year (or Fiscal Year): The annual period used for the assessment of Income Tax and Capital Gains Tax for individuals. In the UK, it runs from 6 April to the following 5 April.

Taxable Person: Any business that is, or is required to be, registered for Value Added Tax (VAT).

V

Value Added Tax (VAT): A consumption tax levied on the value added to goods and services at each stage of the supply chain. It is ultimately borne by the final consumer.

1

INTRODUCTION TO THE UK TAX SYSTEM AND CORE PRINCIPLES

Taxation is the lifeblood of a state, funding public services like the NHS, education, and infrastructure. For a solicitor, however, tax is more than just a government revenue tool; it is a fundamental thread woven into the fabric of nearly every commercial and personal transaction.

Whether you are advising on a company acquisition, drafting a partnership agreement, managing an estate, or structuring an employee's remuneration, a solid understanding of tax principles is not merely an advantage, it is a professional necessity. This chapter lays the foundation for your journey into tax law. We will demystify the core concepts, the key players, and the fundamental distinctions that underpin the entire UK tax system.

Our goal is to build your confidence from the ground up, ensuring you have the conceptual toolkit needed to navigate the more detailed rules that follow in this textbook.

1.1. The Role of the Solicitor in Business Taxation

You might ask, "Why do I, as a future solicitor, need to understand tax? Isn't that for accountants?" This is a common but mistaken belief. While accountants often handle the detailed computation and filing of tax returns, solicitors are the architects of transactions and the guardians of legal structures. The tax consequences of a deal are often the most significant factor determining whether it proceeds and how it is structured.

Your role as a solicitor in business taxation includes:

1. **Transactional advice**: When drafting a contract for the sale of a business, you must understand the Capital Gains Tax implications for your client. Should they sell the company's assets or their shares? The tax outcomes are vastly different.

2. **Structural advice**: When clients start a business, should they operate as a sole trader, a partnership, or a limited company? Each choice has profound and immediate tax consequences, affecting Income Tax, National Insurance, and liability.

3. **Compliance and risk management**: You will need to ensure that transactions you advise on or documents you draft comply with tax law. You have a duty to spot potential tax issues and, where necessary, involve a tax specialist.

4. **Ethical guidance**: You must be able to identify the line between legitimate tax planning (which is lawful) and aggressive tax avoidance or evasion (which is not).

Example: The New Business

Anna wants to start a graphic design business. The professionals involved will do the following;

- **Accountant's role**: Will calculate her eventual profits, claim appropriate expenses, and prepare her tax return.
- **Solicitor's role** (You): Advise Anna on whether to set up as a sole trader or a limited company. You would explain that as a sole trader, all her profits are subject to Income Tax, while as a limited company, profits are subject to Corporation Tax and she can extract profits as a salary (subject to Income Tax) or dividends (subject to Dividend Tax). Your advice shapes the entire tax landscape of her enterprise.

1.2 Overview of the UK Tax Framework: HMRC and Statute

The UK tax system is not a mysterious, unwritten code. It is a highly structured framework built on clear, publicly accessible pillars.

1. **HM Revenue & Customs** (HMRC): This is the government department responsible for collecting taxes, paying tax credits, and enforcing tax law. Think of HMRC as the

"tax referee." They administer the rules, process returns, and conduct enquiries and investigations.

2. **Statute** (Acts of Parliament): The primary source of UK tax law is statute. The main taxes are governed by their own major Acts:

- *Income Tax*: Income Tax Act 2007
- *Corporation Tax*: Corporation Tax Act 2009 and 2010
- *Capital Gains Tax*: Taxation of Chargeable Gains Act 1992
- *Value Added Tax*: Value Added Tax Act 1994
- *Inheritance Tax*: Inheritance Tax Act 1984

3. **Case Law**: The courts interpret the often complex language of the statutes. Their judgments create precedents that HMRC and taxpayers must follow, clarifying the application of the law in specific situations.

1.3. Key Concepts: Tax Year vs. Accounting Period; Residence, Domicile, and Source

These are the fundamental building blocks that determine *when* and *on what* a person or company is taxed.

1.3.1 Tax Year vs. Accounting Period

Tax Year or Fiscal Year for individuals is calculated over a fixed period known as the tax year, which runs from 6 April to the following 5 April. An individual's income and gains are assessed within this specific window.

For example*:* If David earns a salary between 6 April 2024 and 5 April 2025, it is taxable in the 2024/25 tax year.

Companies use their own 12-month trading period, known as their Accounting Period, for Corporation Tax purposes. It is usually, but not always, the same as their financial accounting year.

For example*:* A company with a year-end of 31 December will have an accounting period for Corporation Tax from 1 January to 31 December.

1.3.2 Residence, Domicile, and Source

These three concepts determine who is taxable and on which of their income.

1. **Residence**: This is about where you are. It is a factual test of how much time you spend in the UK. Broadly, if you spend 183 or more days in the UK in a tax year, you are UK tax resident. A UK resident is generally taxable on their worldwide income and gains.

2. **Domicile**: This is more abstract; it's about where your permanent home is. It is the country you consider to be your ultimate home. You acquire a domicile of origin at birth (usually your father's domicile) and it can be difficult to change. The concept is crucial for Inheritance Tax and, for non-UK domiciled individuals, for the taxation of foreign income.

3. **Source**: This is about where the income comes from. The UK taxes income that has a UK source. A UK resident is taxed on worldwide income, but a non-UK resident is generally only taxed on their UK-source income.

Putting it all together with an example:

Ben was born in England but now works for 3 months a year in London, spending the rest of his time in his home in Spain. He earns rental income from a flat he owns in Paris.

Analysis

- **Residence**: He spends fewer than 183 days in the UK, so he may be non-UK resident.
- **Domicile**: His domicile of origin is likely English, unless he has taken clear steps to change it to Spanish.
- **Source**: His salary for the UK work has a UK source. His rental income from Paris has a French source.

Tax Outcome: As a non-UK resident, Ben will only be taxed in the UK on his UK-source income (his salary for the UK work). His French rental income is not taxable in the UK.

1.4. Distinguishing Between Income and Capital

This is one of the most critical distinctions in all of tax law. The nature of a receipt determines which tax applies and how it is calculated.

Income receipts: These are recurring, revenue in nature, and represent the "fruit from the tree." They are the flow of money from trading, employment, or investing. Examples include; salary, business profits, bank interest, dividends, rent.

The tax applied is Income Tax or Corporation Tax.

Capital receipts: These are one-off, non-recurring gains from the sale or disposal of an asset itself; the "tree," not the "fruit." They represent a change in the capital structure. Examples include; selling a factory building, selling shares in a company, selling a sole trader's business.

The tax applied is Capital Gains Tax (for individuals) or chargeable gains within Corporation Tax (for companies).

The "Tree and Fruit" Analogy

Imagine you own an apple tree. The apples you sell each year are the income (trading profit). They are taxed year after year.

The tree itself is the capital asset. If you decide to sell the tree, the profit from that one-off sale is a capital gain.

Example: A Shop Owner

Chloe owns a bookshop. We will now consider her income and capital

Income: The daily sales of books are trading income. This is subject to Income Tax (if she's a sole trader) or Corporation Tax (if the shop is a limited company).

Capital: After 10 years, she sells the shop's premises for more than she bought it for. The profit on the sale of the building is a capital receipt. This is subject to Capital Gains Tax for Chloe personally.

Mixing these up can lead to serious errors, incorrect tax payments, and penalties.

1.5. Introduction to Tax Avoidance vs. Tax Evasion: The General Anti-Abuse Rule (GAAR)

For a solicitor, navigating the boundary between legitimate tax management and illegitimate tax manipulation is not just an academic exercise, it is a core ethical and professional duty. Clients will look to you for guidance on how to structure their affairs efficiently, and you must be able to steer them clear of conduct that could lead to severe financial and legal consequences.

This section breaks down the crucial distinctions between evasion, avoidance, and planning, and introduces the key legislative weapon HMRC uses to combat abuse.

The Spectrum of Tax Conduct

Imagine a spectrum of taxpayer behaviour:

- On one end: Legal, accepted use of the tax system.
- On the other end: Illegal, criminal concealment and fraud.
- In the middle: A grey area of aggressive and artificial schemes that test the limits of the law.

Let's define these categories clearly.

1.5.1 Tax Evasion: The Criminal Act

Tax evasion is illegal. It involves a deliberate and dishonest act of concealing income, transactions, or information from HMRC, or knowingly submitting false documentation.

The key element is intent. The taxpayer knowingly and wilfully sets out to deceive the tax authority to pay less tax than is legally due.

Everyday examples:

- A café owner taking cash payments and deliberately not recording them in the business records to reduce declared profits.
- An employee having a second job and not declaring the income to HMRC on their tax return.
- Claiming personal expenses (like a family holiday) as business travel costs.

The "Stealing a Television" Analogy

Not declaring cash earnings to HMRC is fundamentally the same as stealing a television from a shop. In both cases, you are intentionally taking something of value (money from the public purse; a physical product) that you have no legal right to. The only difference is the directness of the act.

Consequences for the Taxpayer

1. **Criminal prosecution**: This can lead to a criminal record.
2. **Unlimited fines**: The courts can impose fines far exceeding the tax owed.
3. **Imprisonment**: For serious cases, a custodial sentence is a very real possibility.
4. **Naming and shaming**: HMRC can publish the details of deliberate defaulters.

The Solicitor's Role

If a client even hints at evasive practices, your duty is clear: you must advise them in the strongest possible terms of the illegality and severe consequences, and insist on full disclosure and compliance. Failure to do so could implicate you in the criminal activity.

1.5.2 Tax Avoidance: The Artificial Scheme

Tax avoidance involves using the law in a contrived and artificial way to gain a tax advantage that Parliament never intended. These schemes often comply with the strict, literal "letter of the law" but violate its overall "spirit" or purpose. They typically have little or no commercial or business purpose other than to reduce tax.

The key element is artificiality. The transactions lack genuine commercial substance.

The "Loophole in the Store Offer" Analogy

A store runs a "Buy One, Get One Free" (BOGOF) offer on bottles of juice. The intended purpose is for a customer to buy one bottle and get a second one free. An avoider would exploit a technicality: the fine print doesn't say you have to keep the second bottle. So, they buy one bottle, get the free one, and then immediately return the "free" bottle to the customer service desk for a full refund. They end up with a bottle of juice for free, plus a cash refund. They have technically followed the written rules but have completely subverted the intended purpose of the promotion to gain an unfair advantage.

Real-World Example of an Avoidance Scheme

A popular scheme involved employees resigning and being re-hired by an offshore shell company, which then "loaned" them their salary indefinitely. The aim was to avoid Income Tax and National Insurance on their earnings (as loans are not taxable), with no intention of the loan ever being repaid. This is the "Disguised Remuneration" scheme, which HMRC has successfully challenged and shut down.

Consequences for the Taxpayer

1. **The scheme is challenged**: HMRC will investigate and litigate against the scheme.
2. **Tax advantage is counteracted**: The user will have to pay the full tax that would have been due, plus interest from the original due date.
3. **Penalties**: HMRC can levy significant penalties for taking an unreasonable position on a tax return.
4. **Costs and stress**: The user faces years of uncertainty, legal battles, and high professional costs.

1.5.3 Tax Planning (or Mitigation): The Legitimate Course

Tax planning is the legitimate arrangement of your affairs to use the tax reliefs, allowances, and incentives provided by Parliament in the way they were intended. This is not about creating artificial transactions, but about making informed, commercial choices that have a beneficial tax outcome.

The key element is using intended reliefs. The taxpayer is following the "spirit" of the law.

The "Legitimate Store Coupon" Analogy

Using a £5-off coupon that the store has issued and promoted is tax planning. You are using a mechanism provided by the store, for its intended purpose, to reduce your cost. It is transparent, accepted, and encouraged.

Everyday examples for a solicitor

- **For an individual**: Advising a client to save within an Individual Savings Account (ISA) so that their investment growth is tax-free.
- **For retirement**: Recommending pension contributions to gain Income Tax relief.
- **For a business owner**: Structuring the sale of a business to qualify for Business Asset Disposal Relief (BADR), which reduces the Capital Gains Tax rate.
- **For inheritance**: Advising a client to gift assets more than seven years before they die to potentially reduce an Inheritance Tax bill, using the normal Potentially Exempt Transfer (PET) rules.

1.6 The General Anti-Abuse Rule (GAAR): The Legislative Line in the Sand

To combat the persistent problem of aggressive avoidance, Parliament introduced the General Anti-Abuse Rule (GAAR), which applies across Income Tax, Corporation Tax, Capital Gains Tax, and other taxes.

The GAAR gives HMRC the power to counteract ("undo") tax advantages arising from tax arrangements that are deemed "abusive."

The Central Test: What is "Abusive"?

An arrangement is considered "abusive" if, having regard to all the circumstances, it cannot reasonably be regarded as a reasonable course of action in relation to the relevant tax rules.

In simpler terms, would a reasonable person, looking at the tax rules Parliament created, think that this particular arrangement was a fair and reasonable way to act? If the answer is "no," the GAAR can be applied.

How the GAAR Works in Practice

1. HMRC identifies an arrangement it believes is abusive.
2. The case is referred to an independent GAAR Advisory Panel for an opinion.
3. If the Panel agrees it is abusive, HMRC will issue a notice to the taxpayer to counteract the tax advantage. This could involve levying the tax as if the arrangement had never happened, or making other adjustments.

The "Tell-Tale" Signs of an Abusive Arrangement (The GAAR "Triggers")

The GAAR provides indicators of an abusive arrangement. These are red flags a solicitor must watch for:

1. **Circular transactions**: Money goes around in a circle and ends up back where it started, with only a tax saving to show for it.
2. **Contrived steps**: The arrangement includes steps that have no purpose other than to secure a tax reduction.
3. **Inconsistent outcomes**: The result for tax purposes is significantly different from the actual commercial outcome.
4. **Exploitation of loopholes**: The arrangement exploits a shortcoming in the legislation that is clearly at odds with its purpose.

Key Principle for Solicitors: Your Professional Duty

Your role is to be a trusted advisor, not a promoter of risky schemes.

1. **Promote legitimate planning**: Your expertise should be used to help clients structure their affairs using genuine, intended tax reliefs. This is providing value.

2. **Identify and warn**: You must develop a "nose" for avoidance. If a client proposes a scheme, or you are presented with a structure that seems "too good to be true," lacks commercial sense, or is overly complex for the stated goal, it almost certainly is. Your duty is to warn the client of the severe risks, including the high likelihood of HMRC challenge under the GAAR and other anti-avoidance rules.

3. **Protect your client and your profession**: Steering a client away from aggressive avoidance protects them from financial ruin and professional disgrace. It also protects the integrity of the legal profession and the tax system as a whole.

1.7 Conclusion

In conclusion, a solicitor’s involvement in taxation is primarily advisory and strategic rather than numerical. A clear understanding of the UK tax framework; shaped by statute, administered by HMRC, and interpreted through case law, allows the solicitor to provide sound guidance on transactions, business structures, and compliance. Grasping the distinctions between the tax year and accounting period, as well as between residence, domicile, and source, enables proper identification of tax obligations and their scope.

Equally important is the ability to distinguish between income and capital, since this determines the applicable tax regime. The solicitor must also navigate the fine line between illegal tax evasion, legitimate tax planning, and aggressive avoidance. By maintaining professional integrity and recognising the limits established by the General Anti-Abuse Rule (GAAR), the solicitor ensures that advice remains both legally compliant and ethically responsible, supporting the fair and transparent operation of the UK tax system.

2

INCOME TAX FOR BUSINESS AND EMPLOYMENT

Think of income tax like a toll for using the road to earning money. Almost everyone who earns money in the UK must pay this toll. This chapter is your map to understanding how this toll is calculated for different types of travellers: employees, business owners, and investors. We will break down the complex rules into simple, easy-to-follow steps with clear examples. By the end, you will be able to calculate a basic Income Tax bill and understand the key anti-avoidance rules every solicitor must know.

2.1 Chargeable Persons and Entities: Who Pays the Tax?

Your role in the business world determines how you are taxed.

2.1.1 Employees (PAYE)

An employee works for someone else under their direction and control. Their tax is handled automatically by their employer through a system called Pay As You Earn (PAYE).

The employer acts as a tax collector. Every time an employee is paid, the employer calculates the tax and National Insurance due, deducts it from the salary, and sends it directly to HMRC. The employee receives their pay "net" of tax. For most employees, this means they never have to fill out a tax return.

Example: Sarah the Employee

Sarah earns an annual salary of £35,000. Her monthly gross pay is £2,916.67 (£35,000 / 12).

Her employer deducts approximately £400 for tax and £250 for National Insurance. Sarah receives £2,266.67 in her bank account each month.

Her employer pays the £650 directly to HMRC.

2.1.2 Sole Traders

A sole trader is a self-employed person who runs their own business. There is no legal distinction between the individual and the business. The sole trader is personally responsible for all business debts and pays income tax on the total profits of the business.

A sole trader must register with HMRC for self-assessment. They must keep records of all sales (income) and business costs (allowable expenses). The profit for the year is the total income minus the total allowable expenses. This profit is declared on their personal tax return.

Example: Ben the Sole Trader Electrician

In the 2024/25 tax year, Ben's business income from his invoices is £50,000. His business expenses (tools, van costs, insurance) total £12,000.

His taxable trading profit is: £50,000 - £12,000 = £38,000. Ben will pay income tax on this £38,000 profit.

2.1.3 Partners in a Partnership

A partnership is where two or more people run a business together. For tax purposes, the partnership itself is not a separate entity. It is "tax transparent."

The partnership calculates its total business profit. This profit is then divided among the partners according to their partnership agreement. Each partner is then personally responsible for paying Income Tax on their share of the profit via their own Self-Assessment tax return.

Example: Chloe and David's Partnership

Chloe and David are partners and share profits equally. Their partnership makes a profit of £80,000.

Chloe's share of the profit is £40,000. David's share of the profit is £40,000.

Chloe and David each report £40,000 as their personal income and pay tax on it individually.

2.1.4 Shareholders (Dividends)

A shareholder is an owner of a company. When a company makes a profit, it can distribute some of those profits to its owners as dividends. This is a reward for their investment.

Dividends are not the same as a salary. They are paid from profits that have already been taxed under Corporation Tax. The shareholder then pays a separate, special tax on the dividends they receive.

Example: Emma the Shareholder

Emma owns shares in XYZ Ltd. and receives a £10,000 dividend. She must report this £10,000 as "Dividend Income" on her tax return.

She benefits from a tax-free Dividend Allowance (£500 for 2024/25) and pays a lower rate of tax on the rest compared to a salary.

2.1.5 Lenders and Debenture Holders (Interest Income)

This is anyone who earns interest from lending money, whether through a bank savings account or by lending directly to a business.

The interest received is taxable. For most people, some savings interest is tax-free due to the Personal Savings Allowance.

Example: Frank the Lender

Frank lends £50,000 to a business at a 5% interest rate. He receives £2,500 in interest for the year.

Frank must declare this £2,500 as "Savings Income" on his tax return and pay any tax due after using his allowances.

2.2 Basis of Charge: What is Taxed and What is Not?

2.2.1 Types of Income

The UK tax system sorts your money into different buckets. These buckets are stacked in a specific order to calculate your final tax bill.

The order is:

1. **Non-savings income**: This includes:
    - **Trading income**: Profits from being a sole trader or partner.
    - **Employment income**: Salary, bonuses, and benefits like a company car.
    - **Property income**: Rent from properties after deducting expenses.
2. **Savings income**: Interest from bank accounts or loans.
3. **Dividend income**: Dividends from company shares.

2.2.2 Main Reliefs and Exemptions (Tax-Free Amounts)

Before any tax is calculated, everyone gets to earn a certain amount of money tax-free.

Personal allowance: The basic amount everyone can earn before paying tax. The 2024/25 amount is £12,570. This allowance is reduced if your total income is over £100,000.

Trading allowance: This applies to small side businesses. The amount is £1,000. If your total trading income (before expenses) is under £1,000, it is all tax-free. If it's over, you can deduct £1,000 instead of claiming actual expenses.

Property allowance: This is applied to small rental incomes. The amount is £1,000. It works the same way as the Trading Allowance.

Personal savings allowance (PSA): This applies to savings interest. Basic rate taxpayers, who pay income tax at 20%, can earn up to £1,000 in savings interest tax-free. In contrast, higher rate taxpayers, who pay income tax at 40%, are entitled to a smaller £500 tax-free allowance. Additional rate taxpayers, who pay income tax at 45%, do not receive a savings allowance at all

Dividend allowance: This applies to income earned from company dividends. For the 2024/25 tax year, the allowance is £500, meaning the first £500 of dividend income is completely tax-free, regardless of your overall income tax band.

2.3 The Charge to Tax: The Final Calculation

2.3.1 Calculation of Income Tax Liability (England & Wales)

Let's walk through the calculation step-by-step with a detailed example.

Meet Priya. Here is her income for the 2024/25 tax year. The salary from her job is £48,000. The interest from her savings account is £1,200. The dividends from her investments is £4,000.

Step 1: Calculate her Total Income

Total Income = Salary + Interest + Dividends

Total Income = £48,000 + £1,200 + £4,000 = £53,200

Step 2: Deduct the Personal Allowance

Taxable Income = Total Income - Personal Allowance

Taxable Income = £53,200 - £12,570 = £40,630

Step 3: Slice the Taxable Income into the Tax Bands

The tax bands for 2024/25 are:

- Basic Rate Band: £1 to £37,700 (after the Personal Allowance)
- Higher Rate Band: £37,701 to £125,140
- Additional Rate Band: Over £125,140

We fill the bands in the correct order: Non-Savings, then Savings, then Dividends.

Tax on Non-Savings Income (Salary: £48,000)

- The Personal Allowance of £12,570 covers part of the salary. The rest is £35,430.
- This £35,430 fits entirely within the Basic Rate band.
- Tax on Salary = £35,430 x 20% = £7,086

Tax on Savings Income (Interest: £1,200)

- Priya is a basic rate taxpayer, so her Personal Savings Allowance is £1,000.
- The first £1,000 of her interest is tax-free.
- Only the remaining £200 is taxable.
- This £200 fits within the remaining Basic Rate band.
- Tax on Savings = £200 x 20% = £40

Tax on Dividend Income (Dividends: £4,000)

- The Dividend Allowance is £500, so the first £500 is tax-free.
- The remaining £3,500 is taxable.
- This £3,500 fits within the remaining Basic Rate band. Dividends in the basic rate band are taxed at 8.75%.
- Tax on Dividends = £3,500 x 8.75% = £306.25

Step 4: Calculate Total Tax Liability

Total Tax = Tax on Salary + Tax on Savings + Tax on Dividends

Total Tax = £7,086 + £40 + £306.25 = £7,432.25

Summary: Priya's total income tax bill for the year is £7,432.25. Most of the tax on her salary will have been collected by her employer through PAYE. She will likely need to pay the tax on her savings and dividends (£346.25) via the Self-Assessment system.

2.3.2 Collection Mechanisms

Pay As You Earn (PAYE): The automatic system for employees and pensioners. Tax is deducted before you receive your pay. It is simple and requires no action for most people.

Self-assessment: The "do-it-yourself" system for those with more complex finances. This includes:

- Sole traders and partners.
- Individuals with significant untaxed income (e.g., from rents, dividends, or savings above their allowances).

They must register, complete an annual tax return, calculate their own tax, and make payments to HMRC.

2.4 Scope of Anti-Avoidance Provisions: The Rules Against Gaming the System

2.4.1 Disclosure of Tax Avoidance Schemes (DOTAS)

This is HMRC's early warning system. Promoters of complicated tax avoidance schemes are legally required to tell HMRC about them. HMRC gives the scheme a reference number. Anyone using that scheme must put that number on their tax return, which immediately alerts HMRC to scrutinise their affairs. For a solicitor, a client mentioning a scheme with a reference number is a major red flag.

2.4.2 The Loan Charge for Disguised Remuneration

This rule was created to shut down a specific and aggressive avoidance scheme. These schemes paid people with loans from offshore trusts instead of a normal salary. The idea was that loans are not taxable, and if the loan was never meant to be repaid, no tax was ever paid. The Loan Charge legislation treated all such outstanding loans as taxable income in one go, creating a huge tax bill for anyone still using these schemes on 5 April 2019. It serves as a powerful lesson in the risks of aggressive tax planning.

2.4.3 Transactions in Securities Rules

These rules prevent company owners from disguising income as capital to pay less tax. For example, an owner might try to wind up their company and take the profits as a capital distribution (taxed at 10% or 20% under Capital Gains Tax) instead of as a dividend (taxed at up to 39.35% as income). If HMRC can show the main purpose was to gain a tax advantage, it can ignore the transaction and tax the amount as if it were a dividend. When advising on company sales or liquidations, a solicitor must always ensure the transaction has a genuine commercial purpose beyond just saving tax.

2.5 Conclusion

In conclusion, the dividend allowance provides a modest but valuable relief for individuals earning income from company shares. For the 2024/25 tax year, the first £500 of dividend income is exempt from tax, allowing small investors to benefit from a measure of tax efficiency. Beyond this amount, dividend income is taxed progressively according to the taxpayer's income band, ensuring proportionality and fairness in the system.

This structure reflects the balance between encouraging investment and maintaining equitable taxation. By understanding how the dividend allowance interacts with other reliefs, such as the Personal Allowance and Personal Savings Allowance, taxpayers and advisers can plan effectively while remaining compliant with UK tax law

3

TAXATION OF BUSINESS STRUCTURES; SOLE TRADERS AND PARTNERSHIPS

Choosing how to structure a business is one of the first and most important decisions an entrepreneur will make. This choice has profound and immediate tax consequences. In this chapter, we dive deep into the two most common non-corporate business structures: the sole trader and the partnership. We will demystify how trading profits are calculated, how the tax year rules work, and the crucial role of National Insurance. Understanding these rules is essential for any solicitor advising startups, existing businesses, or professional partnerships. The goal is to equip you with the knowledge to guide clients confidently through these fundamental choices.

3.1 Sole Traders

A sole trader is an individual who is the exclusive owner of a business, entitled to keep all profits after tax but personally liable for all losses. It is the simplest and most common business structure.

3.1.1 Calculation of Trading Profits (Adjustments to Accounting Profit)

A business's accounting profit, calculated for its own records, is not the same as its taxable profit. For tax purposes, we must adjust the accounting profit according to rules set by HMRC.

The core principle is that you are taxed on the profits of the trade, not simply the money coming in.

The formula is:

Taxable Trading Profit = Accounting Profit + DISALLOWABLE Expenses - ALLOWABLE Expenses not already included - Capital Allowances

Let's break this down:

Allowable Expenses (Deductible)

These are expenses incurred "wholly and exclusively" for the purposes of the trade. They are the costs of running the business.

Common examples include stock purchased for resale, staff salaries, rent for business premises, business insurance, marketing and advertising costs, utility bills for the business premises, professional fees (e.g., accountant or solicitor).

Disallowable Expenses (Not Deductible)

These are costs that cannot be deducted when calculating taxable profit, even if the business has genuinely paid for them.

Common examples include:

- Client entertainment: Taking a client to lunch.
- Depreciation: This is an accounting estimate for the wear and tear of assets. For tax, we use a specific system called Capital Allowances instead.
- Drawings: Money taken by the owner for their personal use.
- Fines and penalties: e.g., a parking fine received while on business.
- Political donations.
- Private use element: If an expense is part-business, part-private (e.g., a mobile phone bill), only the business portion is allowable.

Capital Allowances

This is the tax version of depreciation. It is a tax deduction for the cost of certain capital assets you buy and keep to use in your business, like machinery, vans, or equipment. There is a special type of capital allowance called the Annual Investment Allowance (AIA), which allows a business to deduct the entire cost of most plant and machinery (excluding cars) up to a generous limit (£1 million for 2024/25) in the year of purchase.

Example: Ben's Building Supplies (Sole Trader)

Ben runs a small building merchant business. His accountant has prepared accounts showing a profit of £55,000. However, this includes:

1. A business lunch with a potential supplier, costing £200. (Disallowable - client entertainment).
2. Depreciation on his delivery van of £3,000. (Disallowable - we use capital allowances instead).
3. His mobile phone bill of £600. Ben estimates 40% of the use was for personal calls. (Part disallowable).
4. He bought a new forklift for the warehouse for £20,000. (This is a capital asset, so we claim the AIA instead of depreciation).

Let's calculate Ben's Taxable Trading Profit.

Step 1: Start with Accounting Profit: £55,000

Step 2: Add Back Disallowable Expenses:

- Client Lunch: £200
- Depreciation: £3,000
- Private Use of Mobile (40% of £600): £240
- Total Add Backs: £200 + £3,000 + £240 = £3,440

Step 3: Deduct Capital Allowances:

- The forklift cost £20,000 and qualifies for the full AIA.
- Capital Allowances Deduction: £20,000

Step 4: Calculate Taxable Profit: £55,000 + £3,440 - £20,000 = £38,440

Ben's taxable profit, on which he will pay Income Tax, is £38,440, not the £55,000 shown in his accounts.

3.1.2 Basis Periods and Overlap Profits

This concept deals with matching the business's profits to the government's tax year (6th April to 5th April). For a new business, its accounting period will rarely align perfectly with the tax year. The rules for doing this are known as the basis period rules.

The Standard Current Year Basis

A sole trader is taxed on the profits of their accounting year that ends in the current tax year.

Example: Starting a Business

Chloe starts her graphic design business on 1st September 2024. She prepares her first accounts to 31st August 2025.

Tax year 2024/25: This runs from 6 April 2024 to 5 April 2025.

Relevant accounts: The accounts that end in the 2024/25 tax year are her first accounts, which end on 31st August 2025.

Basis period: Her basis period for the 2024/25 tax year is from 1 September 2024 (start of trade) to 5 April 2025. This is a short period.

Profit calculation: HMRC will take the profit for the 12-month account to 31 August 2025 and time-apportion it to find the profit for the short period.

Profit for 12 months to 31 Aug 2025 = £30,000

- Days in basis period (1 Sep '24 - 5 Apr '25): 217 days
- Taxable Profit for 2024/25: (£30,000 / 365 days) * 217 days = £17,835

Overlap Profits

A problem arose under old rules where some profits could be taxed twice in the early years of a business. These profits were called "overlap profits." When the business eventually ceases, these overlap profits are deducted from the final year's tax bill to ensure they are only taxed once over the life of the business. While the rules are changing, the concept remains important for existing businesses.

3.1.3 National Insurance Contributions (NICs)

For sole traders, NICs are a significant additional tax on profits, paid on top of Income Tax. There are two main classes:

Class 2 NICs

Class 2 NICs are a flat charge of £3.45 per week for 2024/25, payable when annual profits exceed £6,725. They provide entitlement to state benefits such as the State Pension and Maternity Allowance, offering self-employed individuals a low-cost way to maintain benefit eligibility.

Class 4 NICs

Class 4 NICs are earnings-based, charged at 9% on profits between £12,570 and £50,270, and 2% on profits above £50,270. Paid through the Self-assessment system, they ensure that self-employed individuals contribute proportionally to National Insurance based on income.

Example: David's NICs as a Sole Trader

David is a sole trader with a taxable profit of £45,000 for 2024/25.

Class 2 NICs: His profit is over £6,725, so he must pay.

Annual Cost: £3.45 per week x 52 weeks = £179.40

Class 4 NICs:

Profits between £12,570 and £45,000 = £32,430.

NICs due: £32,430 x 9% = £2,918.70

(No 2% rate is applicable as profits are below £50,270).

Total NICs Bill: £179.40 + £2,918.70 = £**3,098.10**

This is a cost he must budget for in addition to his Income Tax.

3.2 Partnerships

A partnership is the relationship between persons carrying on a business with a view to profit. It is governed by the *Partnership Act 1890*.

3.2.1 The Partnership as a Transparent Entity

For tax purposes, a partnership is "fiscally transparent." This is a crucial concept. It means the partnership itself is not a taxable entity. It does not pay tax on its profits. Instead, the profit is calculated for the partnership as a whole and then "passed through" to the individual partners. Each partner is then taxed on their share of the profit as if they had earned it themselves as a sole trader.

Think of the partnership as a pipe. Profit flows in one end, and it flows out the other end directly to the partners. The pipe itself (the partnership) is empty; it's just a conduit.

3.2.2 Allocation of Profits and Losses among Partners

The total partnership profit is allocated to the partners according to the terms of the Partnership Agreement. If there is no agreement, the default under the Partnership Act 1890 is that profits and losses are shared equally.

Example: "Smith & Jones" Partnership

Smith and Jones are in partnership. Their partnership agreement states that profits are shared 60% to Smith and 40% to Jones. The partnership makes a taxable profit of £100,000.

Smith's share: £100,000 x 60% = £60,000

Jones's share: £100,000 x 40% = £40,000

For tax purposes:

- Smith will add £60,000 to his other income and pay Income Tax and Class 2 & 4 NICs on it.
- Jones will add £40,000 to his other income and pay Income Tax and Class 2 & 4 NICs on it.

The partnership itself pays no tax.

3.2.3 Preparing the Partnership Tax Return and Partners' Personal Returns

The partnership has specific reporting duties:

1. **Partnership tax return**: The "nominated partner" must file a partnership tax return. This return does not calculate a tax bill. It simply shows the partnership's total taxable profit or loss and how this profit or loss has been allocated between the partners.

2. **Partners' personal tax returns**: Each individual partner receives a copy of their share of the profit from the partnership. They then include this figure in the "Partnership" section of their own personal Self-Assessment tax return and calculate their own personal tax liability.

3.2.4 Salaried Member Rules in LLPs

A Limited Liability Partnership (LLP) gives its members the benefit of limited liability like a company, while being treated as a partnership for tax purposes (i.e., it is transparent). However, to prevent what HMRC saw as abuse, the "Salaried Member Rules" were introduced.

These rules are an anti-avoidance measure to stop individuals from being treated as self-employed partners (with lower tax/NICs) when they are, in economic reality, employees.

A member of an LLP is automatically treated as a "salaried member" (i.e., an employee for tax purposes) if they meet all three of these conditions:

1. **Payment is substantially disguised salary**: At least 80% of their remuneration is fixed, or is variable but without reference to the overall profitability of the LLP.

2. **No significant influence**: They do not have significant influence over the affairs of the LLP.
3. **Their capital contribution is less than 25% of their disguised salary**: They have not invested a significant amount of capital into the LLP.

Consequences of being a Salaried Member

1. The LLP must operate PAYE and deduct National Insurance on the member's "salary."
2. The member is taxed as an employee, not as a self-employed partner.
3. This is often more expensive in terms of total NICs for the individual and the LLP.

3.3 Choosing a Business Structure: A Comparative Overview

This is often the first and most crucial piece of advice a solicitor provides to an entrepreneur. The choice between being a sole trader, entering a partnership, or forming a limited company is not just a legal formality; it is a strategic decision with profound implications for tax, personal liability, and administrative burden. There is no one-size-fits-all answer. The best structure depends on the business's profits, its appetite for risk, and its plans for growth.

Let's compare the key considerations.

The Core Trade-Off: Tax Simplicity vs. Liability Protection

Imagine you are advising two different clients:

Client A: Maya, a freelance graphic designer. She is just starting out, expects a first-year profit of around £30,000, and works from home with low risk of causing any major debts or lawsuits.

Client B: Ben and Chloe, who are launching a boutique fitness studio. They will need to sign a lease, hire instructors, and are concerned about the potential for a customer getting injured. They project profits of £80,000.

For Maya (Client A), the simplicity of being a sole trader is likely ideal. For Ben and Chloe (Client B), the liability protection of a limited company is probably essential.

Let's break down the comparison into simple, key areas.

1. **Legal Status and Liability**

Sole trader / partnership: You are the business. There is no legal distinction between you and your business entity. As a result, you have unlimited personal liability. If the business cannot pay its debts, creditors can come after your personal possessions; your house, your car, your savings, to settle the business's bills.

Limited company: The company is a separate legal person from its owners (the shareholders) and its managers (the directors). Consequently, you have limited liability. Your risk is generally limited to the money you have invested in the company. Your personal assets are protected from business creditors (unless you have given a personal guarantee, which is common for bank loans to small companies).

2. **Tax and National Insurance (NICs)**

This is where the calculations become critical. The tax efficiency of each structure changes dramatically as profits grow.

Scenario: Profits of £50,000

Let's compare Emma, who has £50,000 in business profits.

As a sole trader, she pays Income Tax and Class 4 NICs on the entire profit.

Calculation

- Taxable Profit: £50,000
- Personal Allowance: £12,570
- Income Tax on £37,430 @ 20% = £7,486
- Class 4 NICs on (£50,000 - £12,570) = £37,430 @ 9% = £3,369
- Class 2 NICs: £179 (approx)

Total Tax & NICs: £7,486 + £3,369 + £179 = £11,034

The take home pay is £50,000 - £11,034 = £38,966

As a Limited Company (Taking all profit as a salary), the company employs Emma and pays her a £50,000 salary.

Calculation

- Emma's Income Tax and Employee's NICs are similar to the sole trader calculation.
- However, the company must also pay Employer's NICs on her salary.
- Emma's Employee NICs: £3,743
- Company's Employer NICs: £5,308
- Total NICs (Employee + Employer): £3,743 + £5,308 = £9,051

The total cost to the business is £50,000 salary + £5,308 Employer NICs = £55,308.

On a pure salary model, the sole trader is more tax-efficient at this profit level due to the extra cost of Employer's NICs.

The Power of Mixed Extraction in a Limited Company

The real tax advantage for a company emerges when the director-shareholder uses a mixed strategy of a low salary and dividends.

As a Limited Company (Optimised Extraction)

- Profit before tax: £50,000

Step 1: The company pays Emma a salary of £12,570 (using her full Personal Allowance, so no Income Tax or Employee NICs are due).

Step 2: The company pays Corporation Tax on the remaining profit.

Profit after salary: £50,000 - £12,570 = £37,430.

Therefore, corporation Tax @ 25% (assuming small profits rate): £9,358.

Step 3: The after-tax profit can be taken as a dividend.

- Profit for dividend: £37,430 - £9,358 = £28,072

Step 4: Emma's personal tax on the dividend:

  - Dividend Allowance: £500 (tax-free)
  - Taxable Dividend: £28,072 - £500 = £27,572
  - Tax @ 8.75% (basic rate for dividends) = £2,413

Total Tax & NICs: Corporation Tax (£9,358) + Dividend Tax (£2,413) + Employer NICs (minimal on low salary) = approx. £11,771

Emma's Total Take-Home: Salary (£12,570) + Dividend (£28,072) = £40,642. After personal tax, she has roughly £38,229.

Comparison Summary at £50,000 Profit:

- Sole Trader Take-Home: ~£38,966
- Company (Salary only) Take-Home: ~£38,771 (but higher total NIC cost)
- Company (Optimised) Take-Home: ~£38,229

At this level, the sole trader often still has a slight cash advantage due to lower NICs. However, the company offers limited liability.

The Turning Point: Higher Profits

As profits rise above approximately £60,000-£70,000, the limited company typically becomes more tax-efficient. Why?

- **Corporation tax rate**: The small profits rate of 19% (or marginal rate up to 25%) can be lower than the higher Income Tax rate of 40%.
- **NICs cap**: In a company, you can stop paying high salaries that attract 40% tax and 2% NICs, and instead take dividends, which are not subject to NICs at all. A sole trader pays Class 4 NICs at 9% and 2% on all profits above the threshold, with no way to avoid it.

- **Tax planning flexibility**: Profits can be retained within the company for future investment, taxed at the corporation tax rate, rather than being immediately pushed into the owner's personal tax return and potentially taxed at 40% or 45%.

Administrative Burden

Sole Trader / Partnership

- It is relatively simple.
- Must register with HMRC for Self-Assessment.
- Must keep records and file an annual personal tax return.
- No requirement to file public accounts.

Limited Company

- More complex and costly.
- Must be incorporated at Companies House.
- Must file annual accounts and a confirmation statement with Companies House (public record).
- Must operate a PAYE payroll if there are directors or employees.
- Must file a Corporation Tax return with HMRC.
- Directors have statutory duties.

3.4 Conclusion: A Solicitor's Checklist for Advising Clients

In conclusion, choosing the right business structure depends on a client's profit level, risk exposure, administrative capacity, and growth plans. Sole tradership or partnership often suits those with lower profits or minimal risk, offering simplicity and fewer compliance demands. However, as profits increase or exposure to liability grows, incorporating as a limited company becomes more beneficial; providing tax efficiency, limited liability, and greater flexibility for future expansion.

Ultimately, the decision is not fixed. Many businesses begin as sole traders and later incorporate as their operations evolve. The solicitor's role is to provide clarity; balancing tax considerations, risk management, and administrative complexity, to help clients make informed and strategic choices that align with their long-term business objectives.

4

CORPORATION TAX

A limited company is more than just a business structure; it is a separate legal person in the eyes of the law. Just like an individual, this "company person" has to pay tax on its income. This tax is called Corporation Tax. For a solicitor, understanding Corporation Tax is essential when advising on company formations, mergers, acquisitions, and corporate financing.

This chapter will guide you through the fundamental principles of how companies are taxed, from calculating profits to distributing them, and the key anti-avoidance rules that keep the system intact.

4.1 Basis of Charge: Who Pays and On What?

4.1.1 Chargeable Persons: UK-Resident Companies

Corporation Tax is charged on the profits of "companies." But what is a "company" for tax purposes? It's broader than you might think. It includes:

- All UK incorporated limited companies (e.g., Ltd, PLC).
- Unincorporated associations (like clubs and societies).
- Foreign companies with a UK "permanent establishment" (e.g., a branch office).

A company is a UK resident for tax purposes if it is incorporated in the UK. Even if its management and control are overseas, if it was formed under UK Companies House, it is UK tax resident and liable for Corporation Tax on its worldwide profits.

4.1.2 Scope: Worldwide Profits

This is a crucial concept. A UK-resident company is taxed on its worldwide profits. This means if a company based in London has a subsidiary in Germany or earns rental income from a property in Spain, those profits are all subject to UK Corporation Tax. The company cannot escape UK tax by simply earning money overseas. (There are rules to prevent double taxation, but the principle of worldwide profits remains).

4.2 Calculation, Payment and Collection

4.2.1 Calculating Taxable Total Profits

A company's taxable profit is not the same as the accounting profit shown in its financial statements. We start with the accounting profit and then make adjustments required by tax law.

The formula is:

Taxable Total Profits = Accounting Profit + Disallowable Expenses - Allowable Expenses not included - Capital Allowances + Taxable Income not in accounts

Let's break this down with an example.

Example: "BuildIt Ltd." - Calculating Taxable Profit

BuildIt Ltd. is a construction company. Its accountant calculates an accounting profit of £300,000. This figure includes:

1. Depreciation: £30,000. (This is an accounting estimate for wear and tear. For tax, we use Capital Allowances instead).
2. Client entertainment: £5,000 for taking clients to football matches. (This is a disallowable expense).
3. Political donation: £2,000. (Disallowable).
4. Fine: £1,000 for a health and safety breach. (Disallowable).

5. Capital expenditure: The company bought a new crane for £100,000. (This is a capital asset, not an immediate expense. We will claim a Capital Allowance for it).

BuildIt Ltd. also received £10,000 in dividends from shares it owns in another UK company. (This is tax-free income and does not go into the taxable profit calculation).

Let's calculate the Taxable Total Profit for BuildIt Ltd.

Step 1: Start with Accounting Profit: £300,000

Step 2: Add Back Disallowable Expenses:

- Depreciation: £30,000
- Client entertainment: £5,000
- Political donation: £2,000
- Fine: £1,000
- Total add backs: £38,000

Step 3: Deduct Capital Allowances

Let's assume the full £100,000 for the crane qualifies for the Annual Investment Allowance (AIA). Capital Allowances Deduction: £100,000

Step 4: Exempt Income

The £10,000 dividend from another UK company is not taxable. It is left out.

Step 5: Calculate Taxable Total Profit: £300,000 + £38,000 - £100,000 = £238,000

BuildIt Ltd. will pay Corporation Tax on £238,000, not the £300,000 accounting profit.

4.2.2 Capital Allowances vs. Accounting Depreciation

This is a key adjustment. Companies can't claim the accounting "depreciation" of assets as a tax deduction. Instead, they claim a statutory deduction called a Capital Allowance.

The most important capital allowance is the Annual Investment Allowance (AIA). It is a 100% tax deduction for the cost of most plant and machinery (e.g., machines, vans, equipment, computers) in the year you buy them. The limit for 2024/25 is £1,000,000. Effectively, it means a company can deduct the full cost of most equipment purchases from its profits before tax.

Example: Capital Allowance in Action

In the BuildIt Ltd. example above, the company bought a crane for £100,000. Because of the AIA, it can deduct the entire £100,000 from its profit in that year, reducing its taxable profit by that amount. This is a powerful tax incentive for investment.

4.2.3 Loan Relationships and Intangible Assets

Companies have special rules for two specific types of transactions:

Loan relationships: This covers all money a company borrows or lends. The general rule is that interest paid on borrowing is a tax-deductible expense, and interest received is taxable income. This must be accounted for on an "accruals" basis (when it is earned or incurred, not when cash is paid).

Intangible assets: This covers assets like patents, trademarks, and copyrights. Similar to capital allowances, there is a system for claiming tax deductions for the amortisation (the capital version of depreciation) of these assets.

4.2.4 Rates of Corporation Tax and Payment Dates

For the financial year starting 1 April 2024, Corporation Tax is not a single flat rate for all companies. It uses a sliding scale based on profits.

Main rate: 25% - for companies with profits over £250,000.

Small profits rate: 19% - for companies with profits of £50,000 or less.

For companies with profits between £50,001 and £250,000, a system of Marginal Relief applies, which creates an effective marginal tax rate of 26.5% on profits in that band.

Payment Dates

Corporation Tax is due for payment 9 months and 1 day after the end of the accounting period. For example: If a company's accounting period ends on 31 December 2024, its Corporation Tax is due on 1 October 2025.

The company must also file a Corporation Tax return (CT600) with HMRC 12 months after the end of the accounting period.

4.3 Tax Treatment of Company Distributions

4.3.1 Dividends: The Rules and Tax Implications for Shareholders

Dividends are the primary way a company distributes its post-tax profits to its owners (the shareholders). It is critical to understand that dividends are paid out of profits that have already been taxed at the Corporation Tax level.

The Dividend Journey: From Company to Shareholder

Let's follow the money for a shareholder, Sarah, who owns 100% of "Sarah's Solutions Ltd."

1. Company makes a profit: Sarah's Solutions Ltd. makes a pre-tax profit of £100,000.

2. Company pays corporation tax:

- Corporation Tax @ 25% (assuming main rate) = £25,000.
- After-tax profit available for dividend = £100,000 - £25,000 = £75,000.

3. Company declares a dividend: The company decides to pay the entire £75,000 as a dividend to Sarah.

4. Shareholder pays tax on dividend:

- Sarah receives £75,000.
- She can earn £500 tax-free (Dividend Allowance for 2024/25).
- She pays tax on the remaining £74,500. If Sarah is a higher-rate taxpayer, she pays dividend tax at 33.75%.

- Her personal tax bill on the dividend = £74,500 x 33.75% = £25,144.

Summary of the total tax take:

- Company paid: £25,000 in Corporation Tax.
- Sarah paid: £25,144 in Dividend Tax.
- Total tax on the original £100,000 profit: £50,144.

This "double tax" effect is a fundamental characteristic of the corporate tax system.

4.3.2 Legal vs. Illegal Dividends

A dividend is only legal if it is paid out of distributable profits (accumulated, realised profits not already distributed or capitalised). A company cannot pay a dividend if it has no profits, even if it has lots of cash in the bank.

Legal dividend: This is paid from retained profits. This is lawful.

Illegal dividend (or 'Ultra Vires' Dividend): This is paid from capital or when the company is loss-making. This is a breach of the *Companies Act 2006*.

Consequences of an Illegal Dividend

1. Shareholders may be legally required to repay the dividend to the company.
2. Directors who authorised the illegal payment can be held personally liable.
3. It can have serious implications for the company's solvency and the directors' fiduciary duties.

A solicitor's duty: When advising on company distributions, you must ensure that the company has sufficient distributable reserves to legally declare a dividend.

4.4 Outline of Anti-Avoidance Legislation

The government has created powerful rules to prevent large companies from artificially shifting profits out of the UK tax net.

4.4.1 Transfer Pricing

This is one of the most important anti-avoidance rules.

The Problem: A multinational group could have one company in a high-tax country (like the UK) and one in a low-tax country (like Bermuda). The UK company could "sell" its goods or services to the Bermuda company at an artificially low price, shifting profit out of the UK and into Bermuda, reducing the group's overall tax bill.

The Solution (Transfer Pricing): The law requires that transactions between connected parties (e.g., companies in the same group) must be conducted at an "arm's length price". Arm's Length Price is the price that would have been agreed upon by two independent, unrelated companies in the same commercial circumstances.

Example of Transfer Pricing

- UK Sub Ltd. manufactures widgets. Its parent company is in a tax haven.
- The cost to make a widget is £80.
- The market price to sell to an independent customer is £150.
- If UK Sub Ltd. sells the widgets to its parent company for £85 instead of £150, it is shifting £65 of profit per widget out of the UK.
- HMRC's Action: Under Transfer Pricing rules, HMRC can adjust the price back to the £150 arm's length price and charge Corporation Tax on the true profit.

4.4.2 Controlled Foreign Companies (CFC) Rules

These rules complement Transfer Pricing.

The problem: A UK company could set up a subsidiary in a low-tax country and shift all its profits there, leaving the UK company with little or no profit.

The solution (CFC Rules): These rules allow HMRC to "look through" the foreign subsidiary and charge the UK parent company Corporation Tax on the foreign subsidiary's profits as if they were the UK parent's own profits, if the main purpose is to avoid UK tax.

4.4.3 Corporate Interest Restriction

This rule limits how much interest expense a large group can deduct for tax purposes.

The problem: A group could load up its UK company with debt (from a related party overseas) and claim huge interest deductions to wipe out its UK profits.

The solution: The rule generally restricts a group's net interest deductions to 30% of its UK taxable earnings (with some complex exceptions). Any interest expense above this limit is disallowed and cannot be used to reduce taxable profits.

4.5 Conclusion

- Basis of Charge: Corporation Tax is charged on the worldwide profits of UK-resident companies.
- Calculation: Taxable profit is the accounting profit adjusted for tax rules, most notably by replacing depreciation with capital allowances like the AIA.
- Payment: Tax is due 9 months and 1 day after the company's year-end.
- Distributions: Dividends are paid from post-tax profits and are then taxed again in the hands of the shareholder, creating a double tax effect. Declaring a dividend without distributable profits is illegal.

Anti-Avoidance: The UK has a robust defensive system, including Transfer Pricing (ensuring arm's length prices), CFC rules (attributing foreign subsidiary profits), and the Corporate Interest Restriction (limiting interest deductions) to protect the UK tax base from artificial erosion. For a solicitor, understanding these rules is vital for ensuring corporate transactions are both effective and compliant.

5

CAPITAL GAINS TAX IN A BUSINESS CONTEXT

Imagine you buy a house, live in it for years, and then sell it for more than you paid. The profit you make is not your regular income from a job; it's a one-off gain from selling a valuable asset. Capital Gains Tax (CGT) is the tax on that profit. In a business context, this happens all the time: a sole trader sells their business, a partner sells their partnership share, or an investor sells their company shares. This chapter explains how CGT works, how to calculate the tax, and the valuable reliefs that can significantly reduce the bill. For a solicitor, this knowledge is critical when advising on business sales, restructuring, and succession planning.

5.1 Chargeable Persons and Entities: Who Pays CGT?

CGT is generally a tax on individuals and trustees. Companies do not pay CGT; instead, their capital gains are added to their trading profits and taxed under Corporation Tax.

5.1.1 Individuals (Sole Traders, Partners, Shareholders)

Any individual who disposes of a chargeable asset is potentially liable to CGT. In business, this includes:

- **Sole traders**: Selling their business premises or the entire business as a going concern.
- **Partners**: Selling their share in the partnership.
- **Shareholders**: Selling their shares in a company.

5.1.2 Trustees

Trustees are the legal owners of assets held in a trust. If they sell a trust asset and make a gain, they are liable to pay CGT on that gain, with their own set of tax rates and allowances.

5.2 Basis of Charge: How is the Gain Calculated?

The core calculation for CGT is very simple. The challenge lies in correctly identifying the numbers to plug into the formula.

5.2.1 Calculation of the Gain: Disposal Proceeds less Allowable Costs

The basic formula is:

Chargeable gain = Disposal proceeds - Allowable costs

Disposal Proceeds: This is usually the sale price. It can also be the market value if the asset is given away as a gift.

Allowable Costs: These are the costs you can deduct to work out your gain.

5.2.2 Allowable Deductions: Acquisition and Enhancement Costs

You can deduct more than just the original purchase price. Allowable costs include:

1. **The acquisition cost**: What you paid to buy the asset.
2. **Enhancement costs**: Money spent to improve the asset (not routine repairs). For example, adding an extension to a business property.
3. **Costs of acquisition and disposal**: Professional fees like solicitor's and accountant's fees for buying and selling the asset.

Example: Sarah Sells a Business Property

Sarah bought a commercial warehouse for her business 10 years ago.

Purchase price: £200,000

Solicitor's fees on purchase: £5,000

Cost of building a new roof (an improvement): £30,000

She now sells the warehouse for £400,000.

Estate agent's fees on sale: £10,000

Let's calculate her chargeable gain.

Disposal proceeds: £400,000

Allowable costs:

- Purchase price: £200,000
- Purchase fees: £5,000
- Enhancement (new roof): £30,000
- Sale Fees: £10,000
- Total allowable costs: £245,000

The chargeable gain is £400,000 - £245,000 = £155,000

This £155,000 is the figure on which Sarah may have to pay CGT.

5.3 Main Reliefs and Exemptions: Reducing the Tax Bill

For a business owner, a large capital gain can feel like a penalty for being successful. The government recognises this and has created a system of reliefs to encourage entrepreneurship, facilitate business growth, and allow for sensible succession planning. Understanding these reliefs is perhaps the most valuable skill a solicitor can bring to a client facing a business disposal or restructuring. They are not loopholes; they are intentional provisions designed to support the business ecosystem.

5.3.1 Annual Exempt Amount

Think of this as your annual "tax-free shopping" allowance for capital gains. It works exactly like the personal allowance for income tax, but for gains. Its purpose is to prevent the administrative burden of collecting trivial amounts of tax on small gains, and to allow individuals to make modest disposals without a tax concern.

How it works: It's a "use it or lose it" allowance. It cannot be carried forward to future tax years.

Important nuance: The allowance is applied to your net gains for the year (total gains minus total losses). You cannot cherry-pick which gain to use it against.

Example 1: Simple Use of the Annual Exempt Amount

Maria sells a vintage car she has collected, making a gain of £2,500. She has no other gains or losses in the tax year. Her gain of £2,500 is less than the £3,000 Annual Exempt Amount.

Result: Maria pays £0 in Capital Gains Tax. She does not even need to report this on a Self-Assessment tax return.

Example 2: Multiple Gains and the Annual Exempt Amount

Tom has two gains in the 2024/25 tax year; gain from selling shares as £4,000 and gain from selling a piece of business equipment as £1,500. The total gains is £5,500.

He deducts his Annual Exempt Amount: £5,500 - £3,000 = £2,500

As a result, Tom will pay CGT on the net gain of £2,500.

5.3.2 Business Asset Disposal Relief (BADR); formerly Entrepreneurs' Relief

This is the premier relief for business owners selling all or part of their life's work. It is a powerful incentive, but its conditions are strict and must be met precisely.

Expanded Qualifying Conditions

To qualify for BADR when selling all or part of your business, you must meet all of the following conditions for at least 2 years leading up to the date of sale:

1. You are a sole trader or business partner AND
2. You own the business assets.

For shareholders selling shares in their personal trading company, the conditions are:

1. You are an employee or office holder (e.g., a director) of the company AND
2. The company is your "personal trading company" (meaning you hold at least 5% of the ordinary share capital and voting rights).

Example 1: Sole Trader Sale

Ben has run his own landscaping business as a sole trader for 10 years. He sells the entire business, including his goodwill, equipment, and van. The chargeable gain on the business assets is £500,000.

Ben has never used BADR before.

Without BADR, as a higher-rate taxpayer, his CGT would be 20% of £500,000 = £100,000.

With BADR, the gain is taxed at a flat rate of 10%. CGT = 10% of £500,000 = £50,000.

The tax saved is £50,000. Ben's lifetime BADR limit remaining is £1,000,000 - £500,000 = £500,000.

Example 2: Shareholder Selling Shares

Anya is a founder and director of "TechSolve Ltd.", a software company. She owns 15% of the shares, which she bought for £50,000 ten years ago. She sells her entire shareholding for £800,000. Her gain is £800,000 - £50,000 = £750,000.

She has been a director and 15% shareholder for the entire 10 years, so she qualifies for BADR.

CGT with BADR: £750,000 x 10% = £75,000.

Without BADR, her tax could be up to £750,000 x 20% = £150,000.

Example 3: The Pitfall; Failing the 2-Year Test

Charles buys a 30% stake in a partnership on 1st January 2024. He sells his partnership share on 1st December 2025.

Analysis: Although Charles has owned the share for nearly two years, he has not held it for the full two years leading up to the disposal. The qualifying period is from 2nd December 2023 to 1st December 2025. He fails the test.

As a result, the gain on the sale does not qualify for BADR and will be taxed at 20%.

5.3.3 Incorporation Relief (Transfer of a Business to a Company)

This relief exists to make it easier for successful sole traders and partnerships to take the next step and incorporate without facing an immediate, potentially crippling, tax bill. The relief is automatic if you qualify; you do not need to make a claim, but you can elect for it not to apply.

Key Conditions

- You must transfer the whole business (it can include all assets except cash) as a going concern.
- The business must be transferred wholly or partly in exchange for shares in the new company.

Example: Chloe's Consultancy

Chloe has run a successful marketing consultancy as a sole trader. Her business has the following assets at market value:

- Goodwill (the value of the business name and client list): £180,000
- Office equipment: £20,000
- Business van: £25,000
- Debtors (money owed by clients): £75,000

The total business value is £300,000

Her total allowable costs for these assets were £100,000. This means she has a potential chargeable gain of £200,000.

She transfers the entire business (except the cash and debtors, which she takes out) to a new company, "Chloe Ltd." In return, the company issues her with 300,000 £1 ordinary shares, worth £300,000.

Without incorporation relief, Chloe would have an immediate CGT bill on the £200,000 gain. At 20%, this would be £40,000. She would have to find this cash from her personal savings, as the company's money is not hers to use.

With incorporation relief (Automatic): The gain is deferred. The calculation is based on the proportion of the business value received in shares.

Total value of business transferred: £300,000

Value received in shares: £300,000

Proportion received in shares: 100%

Gain eligible for relief: 100% of £200,000 = £200,000.

New Base Cost of Shares: The market value of the shares (£300,000) minus the deferred gain (£200,000) = £100,000.

The Long-Term Outcome

Five years later, Chloe sells all her shares in Chloe Ltd. for £600,000.

Her chargeable gain on the shares is: £600,000 (sale price) - £100,000 (base cost) = £500,000.

This £500,000 gain includes the original £200,000 gain from the incorporation, which has now been realised. She will pay CGT on the £500,000 at that time, which may qualify for BADR.

5.3.4 Hold-Over Relief for Gifts of Business Assets

This relief facilitates business succession and family business planning by removing the immediate tax barrier to gifting business assets. Without it, a business owner might be forced to sell the business to a third party to raise cash to pay the tax bill, rather than passing it on to the next generation.

Key Conditions

- The asset must be a business asset (e.g., assets used in a trade, shares in a trading company, etc.).
- Both the donor (giver) and the recipient (receiver) must jointly elect in writing to HMRC.

Example: The Family Manufacturing Company

David founded "Precision Components Ltd." 30 years ago. His son, Liam, now works in the business. David wants to gift 40% of the company shares to Liam to gradually hand over control. The shares have a market value of £400,000.

David's original cost for these shares was a nominal £10,000. The potential gain is therefore £390,000.

Without hold-over relief, David would be deemed to have sold the shares at market value. He would face an immediate CGT bill of 20% on £390,000 = £78,000. He would have to find this cash personally, which could be difficult as he received no cash from the gift.

With hold-over relief (joint election), David pays £0 CGT at the time of the gift.

Thus, Liam's acquisition cost for the shares is deemed to be: £400,000 (Market Value) - £390,000 (Held-Over Gain) = £10,000.

The Long-Term Outcome

Ten years later, Liam sells the shares for £750,000.

Liam's chargeable gain is: £750,000 (sale price) - £10,000 (base cost) = £740,000.

This £740,000 includes the original £390,000 gain that was held over from his father. Liam will pay CGT on the full £740,000 when he sells.

Example 2: Gifting a Business Property

Eleanor owns a warehouse that her company uses in its trade. She gifts the warehouse to her daughter, who continues to rent it to the company.

Market Value: £500,000.

Original Cost: £150,000.

Potential Gain: £350,000.

They make a hold-over election. As a result, Eleanor pays no CGT. Her daughter's base cost becomes £500,000 - £350,000 = £150,000. The £350,000 gain is deferred until the daughter sells the property.

These reliefs are powerful tools in a solicitor's toolkit. Their application turns a potentially prohibitive tax event into a manageable one, enabling business growth, transition, and succession. The key for a solicitor is to:

1. Identify the opportunity early in the planning process.
2. Scrupulously check the qualifying conditions to ensure the client will be eligible.
3. Clearly explain the long-term consequences to the client, particularly the deferred tax liability that arises with Incorporation and Hold-Over Relief.

Mastering these reliefs allows you to provide strategic, value-added advice that goes far beyond mere compliance.

5.4 The Charge to Tax: The Final Calculation

5.4.1 Calculation of CGT Liability and Rates for Individuals

CGT rates depend on your level of total taxable income. The process is:

1. Calculate your total taxable gains for the year.
2. Deduct your Annual Exempt Amount (£3,000).
3. Add this net gain to your total taxable income for the year.
4. Apply the CGT rates to the net gain.

CGT Rates (2024/25)

Basic Rate Band (if any gain falls within): 10%

Higher/Additional Rate Band (if any gain falls above): 20%

For Residential Property (not main home) and Carried Interest: 18% (basic), 24% (higher)

BADR overrides these rates and applies a flat 10% to qualifying gains.

Example: Emma's CGT Calculation

Emma is a higher-rate taxpayer with a salary of £55,000. She sells a business asset qualifying for BADR, realising a gain of £250,000. She also sells an investment painting, realising a gain of £15,000. She has no other gains or losses.

Step 1: Calculate Total Gains

Business asset gain: £250,000

Painting gain: £15,000

Total gains: £265,000

Step 2: Deduct Annual Exempt Amount

£265,000 - £3,000 = £262,000 Net Gains

Step 3: Apply Reliefs (BADR)

The business asset gain qualifies for BADR. It will be taxed at 10%, regardless of her income. The painting gain does not qualify and will be taxed at the standard rates.

Step 4: Calculate Tax Liability

Tax on Business Asset (BADR): £250,000 x 10% = £25,000

Tax on Painting Gain

Emma's income (£55,000) already uses up her basic rate band (up to £50,270). The remaining basic rate band is £0. Therefore, the entire £15,000 gain from the painting falls in the higher rate band and is taxed at 20%.

Tax = £15,000 x 20% = £3,000

Step 5: Total CGT Liability

£25,000 (BADR) + £3,000 (Painting) = £28,000

5.4.2 Collection via Self-Assessment

CGT is reported and paid through the Self-Assessment system. For most gains, the tax is due by 31 January following the end of the tax year. However, for gains on UK residential property, you must report and pay the tax within 60 days of completion using a "UK Property Disposal Return."

5.5 Scope of Anti-Avoidance Provisions

5.5.1 Transactions between Connected Persons

Connected persons include your spouse/civil partner, relatives (siblings, parents, children), and business partners. To prevent people from selling assets to family members at a low, artificial price to avoid CGT, a special rule applies.

The rule is that when you dispose of an asset to a connected person, the transaction is deemed to take place at market value, not the actual price paid. A s a result, you cannot create an artificial loss or a low gain by selling to your brother for £1. HMRC will ignore the £1 and tax you based on what the asset is truly worth.

5.5.2 The Substantial Shareholding Exemption (SSE) for Companies

This is a very important exemption for corporate groups. Remember, companies don't pay CGT, but they do pay Corporation Tax on their capital gains. The SSE is a major relief from this.

It makes the gain on the disposal of shares by a company completely exempt from Corporation Tax. The company selling the shares must have held a "substantial shareholding" (generally at least 10%) in the company being sold for a continuous 12-month period in the 6 years before the sale. Both companies must be trading companies.

The purpose of the exemption is to encourage groups to restructure and dispose of trading subsidiaries without a tax penalty, making the UK a more competitive place for corporate headquarters.

Example: SSE in Action

"UK Holdings Ltd." owns 100% of "Trading Sub Ltd." for 5 years. It sells all the shares for a gain of £50 million.

Thanks to the SSE, the £50 million gain is entirely exempt from Corporation Tax.

Without the SSE, the gain would be taxed at 25%, a bill of £12.5 million.

Conclusion

In conclusion, Capital Gains Tax (CGT) plays a central role in the taxation of individuals and trustees upon the disposal of assets, calculated simply as the difference between sale proceeds and the asset’s original or improvement cost. While the Annual Exempt Amount (£3,000) offers some relief, the effective tax rate, 10% or 20% depending on income level, makes careful planning essential. For business owners, reliefs such as Business Asset Disposal Relief (BADR), Incorporation Relief, and Hold-Over Relief provide significant opportunities to reduce or defer tax liabilities when used appropriately.

The system also incorporates strong anti-avoidance provisions, including rules for connected persons (ensuring fair market valuation) and the Substantial Shareholdings Exemption (SSE), which allows full exemption for qualifying corporate share disposals. For solicitors, mastery of these principles is vital, not only to ensure compliance, but to structure transactions efficiently, protect clients' interests, and promote genuine commercial growth within the boundaries of the law.

6

VALUE ADDED TAX

Value Added Tax, or VAT, is a tax on spending. Unlike income tax or corporation tax, which are taxes on profit, VAT is a tax on the value a business adds to its goods and services at each stage of production and distribution. It is ultimately paid by the final consumer, but businesses act as tax collectors for the government. For a solicitor, understanding VAT is crucial because it affects almost every commercial transaction, from drafting a sales contract to advising on a multi-million-pound business acquisition. A mistake can be costly for a client, making this a key area of risk and opportunity.

6.1 Key Principles: The Engine of VAT

6.1.1 Scope: Taxable Supplies in the UK

VAT is charged on "taxable supplies" made by a "taxable person" (a VAT-registered business) in the course of their business within the UK.

Taxable person: Any business that is, or is required to be, registered for VAT.

Taxable supply: This is a wide term covering sales, hires, barter exchanges, and even gifts in some cases.

In the UK, VAT is a territorial tax. Supplies outside the UK have different rules (often zero-rated or outside the scope).

6.1.2 The Concept of Supply: Goods vs. Services

All business transactions subject to VAT fall into one of these two categories. The distinction can sometimes be tricky (e.g., is software a good or a service?), but it's important as it can affect the place of supply and the rate of VAT.

Goods: Physical, tangible items. (e.g., a laptop, a chair, a loaf of bread).

Services: Something done for a customer. (e.g., legal advice, a haircut, an accounting service).

6.1.3 Input Tax and Output Tax: The Heart of the System

This is the core mechanism of VAT. Think of it like a relay race where the baton (the VAT) is passed along until it reaches the final runner (the consumer).

Output tax: This is the VAT a business charges its customers when it sells something. The business is collecting tax for HMRC.

Input tax: This is the VAT a business pays its suppliers when it buys goods and services for the business. The business is suffering tax.

The Net Principle

At the end of each accounting period, a business calculates:

VAT to pay to HMRC = Output Tax collected from customers - Input Tax paid to suppliers

If the result is positive, the business pays HMRC. If it's negative, the business gets a refund from HMRC.

Example: The Journey of a Wooden Table

Let's follow a £100 table through the supply chain. Assume the VAT rate is 20%.

1. The Logger (TimberCo) sells wood to the Furniture Maker.

   TimberCo sells wood for £50 + £10 VAT (20% of £50).

   TimberCo's Output VAT: £10. They must pay this to HMRC.

2. The Furniture Maker (Furniture Ltd.) buys the wood and makes a table.

They pay £50 + £10 VAT for the wood. This £10 is their input tax.

They sell the finished table to a Furniture Shop for £120 + £24 VAT.

Furniture Ltd.'s Output VAT: £24. VAT to pay HMRC: £24 (Output) - £10 (Input) = £14.

3. The Furniture Shop (Retail Furnishings) buys the table and sells it to you, the consumer.

They pay £120 + £24 VAT for the table. This £24 is their Input Tax. They sell the table to you for £200 + £40 VAT. Retail Furnishings' Output VAT: £40.

VAT to pay HMRC: £40 (Output) - £24 (Input) = £16.

The Final Consumer (You)

You pay £240 for the table, which includes £40 VAT. You cannot reclaim this VAT. You are the final link in the chain and bear the full cost of the tax.

Total VAT collected by HMRC: £10 (Logger) + £14 (Maker) + £16 (Shop) = £40. This is 20% of the final selling price of £200.

6.2 Registration Requirements: When You Have to Play the Game

6.2.1 Compulsory Registration (Exceeding the Threshold)

A business must register for VAT if the total value of its taxable supplies (its VATable turnover) in the last 12 months has exceeded the registration threshold. The current threshold as at 2024 is £90,000.

This is a rolling test. At the end of every month, you must look back at the previous 12 months and add up your turnover. If it goes over £90,000, you have 30 days to notify HMRC.

Example: Compulsory Registration

Sarah runs a catering business. Her monthly turnover is consistently £8,000. On 31st October, she looks back at her turnover from 1st November last year to 31st October this year.

Total turnover = 12 months x £8,000 = £96,000.

This is over the £90,000 threshold. Therefore, Sarah must notify HMRC by 30th November. Her VAT registration will be effective from 1st December (or a date agreed with HMRC).

6.2.2 Voluntary Registration

A business with a turnover below the threshold can choose to register for VAT. This might seem counter-intuitive, but it can be beneficial.

Reasons to register voluntarily:

1. **To reclaim input tax**: If your business makes a lot of VATable purchases (e.g., you buy a lot of expensive equipment, or you are a new business with high start-up costs), registering for VAT allows you to reclaim the input tax on those purchases, improving your cash flow.
2. **To appear larger**: Being VAT registered can make a small business appear more established to potential clients and suppliers.
3. **If your customers are VAT-registered**: If you mainly sell to other VAT-registered businesses, they won't mind the 20% extra charge because they can reclaim it as input tax.

6.3 VAT Invoices, Returns, and Record Keeping: The Administration

6.3.1 Contents of a Valid VAT Invoice

Once registered, you must issue a proper VAT invoice for all standard-rated and zero-rated sales to other VAT-registered businesses. A valid invoice must include:

- A unique invoice number.
- Your business name, address, and VAT number.
- The customer's name and address.
- The date of the supply and the invoice date.
- A description of the goods or services.
- The rate of VAT and the amount payable, excluding VAT.
- The total amount of VAT charged.
- The unit price (e.g., per hour, per item).

6.3.2 Completing the VAT Return

VAT-registered businesses usually have to file a return online every 3 months. The return summarises your VAT activity for that period.

The VAT return has key boxes:

Box 1: VAT due on sales (Output Tax) - The total VAT you've charged your customers.

Box 2: VAT due on acquisitions from EU - (Currently not in use post-Brexit).

Box 4: VAT reclaimed on purchases (Input Tax) - The total VAT you've paid to your suppliers.

Box 5: Net VAT to pay/repay - This is Box 1 minus Box 4.

Box 6: Total sales excluding VAT - Your total turnover.

Box 7: Total purchases excluding VAT - Your total business purchases.

Example: Completing a VAT Return for "Consulting Ltd."

In a 3-month period, Consulting Ltd. has:

Sales to clients: £50,000 + £10,000 VAT.

Purchases from suppliers: £20,000 + £4,000 VAT.

Their VAT return would look like this:

Box 1 (Output Tax): £10,000

Box 4 (Input Tax): £4,000

Box 5 (Net VAT): £10,000 - £4,000 = £6,000 (This is payable to HMRC)

Box 6 (Total Sales): £50,000

Box 7 (Total Purchases): £20,000

6.3.3 Payment and Recovery of VAT

Payment: The VAT return and the payment (the figure in Box 5) are due one calendar month and 7 days after the end of the VAT period. For example*:* For the VAT period 1st April - 30th June, the return and payment are due by 7th August.

Recovery (VAT Refund): If your input tax (Box 4) is greater than your output tax (Box 1), Box 5 will be a negative number. HMRC will then send you a refund.

6.3.4 Record-Keeping Requirements

You must keep all business and VAT records for at least 6 years. This includes:

- Sales and purchase invoices.
- All VAT returns.
- Bank statements.
- The VAT account (a summary showing how you calculated the figures for your VAT return).

6.4 VAT Schemes for Businesses: Simplifying the Process

The standard method of accounting for VAT; tracking every input and output tax amount, can be administratively burdensome for small businesses. To ease this burden, HMRC has developed special VAT schemes. These are optional systems that simplify the VAT calculation and can significantly improve a business's cash flow. For a solicitor, understanding these schemes is vital when advising clients on their operational setup, as choosing the right scheme can save both time and money.

1. **The Cash Accounting Scheme**

The Cash Accounting Scheme fundamentally changes the point at which VAT becomes due or reclaimable. It shifts the focus from the creation of a debt (the invoice) to the actual movement of cash (the payment).

The Core Principle

Under standard VAT accounting, a business must pay the output VAT to HMRC based on the date of their sales invoice, regardless of whether the customer has paid. Similarly, they can reclaim input VAT based on the date of a purchase invoice, even if they haven't yet paid their supplier. This is known as the "invoice basis."

The Cash Accounting Scheme replaces this with the "cash basis." Here, you only account for VAT on a sale when you have actually received payment from your customer. You can only reclaim VAT on a purchase when you have actually paid your supplier.

Example: The Struggling Artist

An artist, Clara, sells a large painting to a gallery in September for £2,400 plus £480 VAT (20%), raising a total invoice of £2,880. The gallery's payment terms are 90 days, so Clara doesn't receive the money until December.

Under Standard VAT Accounting (Invoice Basis):

Clara's VAT period runs from 1st September to 30th November. She must include the £480 output VAT on her VAT return for this period, which is due for payment to HMRC by 7th January.

The problem that arises is that Clara has to find £480 from her own funds to pay HMRC in January, despite not having received the money from the gallery. This creates a serious cash flow problem.

Under the Cash Accounting Scheme:

Clara receives the £2,880 payment in December. Her next VAT period is 1st December to 28th February. She includes the £480 output VAT on the VAT return for this later period, which is not due for payment until 7th April.

The benefit of this scheme is that Clara only pays the VAT to HMRC after she has the customer's cash in her bank account. Her cash flow is protected.

The same principle applies to purchases. If Clara buys £500 of canvases plus £100 VAT on credit in October, she cannot reclaim the £100 input tax until she has actually paid the supplier.

Key consideration for solicitors: This scheme is highly advantageous for businesses that give their customers lengthy credit terms or that have issues with late payers. It aligns the VAT payment to HMRC with the actual receipt of funds.

2. The Flat Rate Scheme (FRS)

The Flat Rate Scheme is designed for simplicity. It dramatically reduces the bookkeeping required by eliminating the need to record every individual item of input and output tax.

The Core Principle

Instead of calculating the difference between output VAT charged and input VAT paid, a business using the FRS simply pays HMRC a fixed percentage of its total VAT-inclusive turnover. This fixed percentage varies by industry and is intended to represent the average net VAT that a business in that sector would pay.

A crucial feature of this scheme is that, with one exception, the business cannot reclaim the input VAT on its day-to-day purchases. The benefit of the scheme is the administrative saving and the potential to retain the difference between the VAT you charge customers and the lower amount you pay to HMRC.

Example: The IT Consultant

David is a sole trader IT consultant. His sector's flat rate percentage is 14%. In a three-month period, his business activity is as follows:

- Total sales to clients (including 20% VAT): £30,000.
- The VAT he charged his clients was £5,000 (as £25,000 + £5,000 VAT = £30,000).
- Business purchases (including VAT): £2,400. The input VAT on these was £400.
- Under Standard VAT Accounting:
    - Output VAT to pay HMRC: £5,000
    - Input VAT to reclaim from HMRC: £400
    - Net VAT to pay: £5,000 - £400 = £4,600
- Under the Flat Rate Scheme:
    - David simply takes his total turnover, including VAT: £30,000.
    - He applies his flat rate percentage: £30,000 x 14% = £4,200
    - This £4,200 is his final VAT bill to HMRC. He does not need to track the £400 input VAT on his purchases.

Analysis: By using the Flat Rate Scheme, David pays £400 less to HMRC (£4,600 - £4,200 = £400). This £400 effectively compensates him for the input tax he cannot reclaim and rewards him for the simpler accounting. For a business like David's with low expenses, this is a clear financial and administrative win.

The "Limited Cost Business" Rule

To prevent businesses with very low material costs from benefiting unfairly, a special rule applies. A "limited cost business" is one where goods for resale, materials, or services used in the business account for less than 2% of its turnover, or less than £1,000 per year. Such businesses must use a higher flat rate of 16.5%. This often affects service-based firms like consultants and hairdressers.

The Exception for Capital Assets

The one major exception to the "no input tax reclaim" rule is for capital assets. A business using the FRS can still reclaim the input VAT on a single purchase of a capital asset where the cost, including VAT, is £2,000 or more. For example, if David bought a new server for his business for £2,400 including £400 VAT, he could reclaim that £400 separately, in addition to using the flat rate for his other sales.

Key consideration for solicitors: The FRS is best suited to businesses with low levels of VATable purchases. A client with high purchase costs (like a retailer who buys stock) would likely be worse off under this scheme. Advising a client requires a simple calculation to compare their potential liability under both the standard and flat rate systems.

6.5 Conclusion

In conclusion, Value Added Tax (VAT) operates as a transaction-based tax on consumer spending, collected incrementally at each stage of the supply chain. Businesses act as intermediaries, charging Output Tax on sales and reclaiming Input Tax on purchases, remitting only the net amount to HMRC. Proper registration is essential once turnover exceeds £90,000, though voluntary registration may benefit smaller firms seeking improved credibility or cash flow management.

Given its strict administrative requirements; including accurate invoicing, quarterly returns, and six years of record-keeping, understanding VAT is indispensable for compliance and sound business planning. For solicitors, this knowledge extends beyond compliance to strategic application: advising on contract terms, business structures, and cash flow. With tools like the Cash Accounting and Flat Rate Schemes, small businesses can simplify their VAT obligations, ensuring both efficiency and adherence to the law.

7

INHERITANCE TAX AND BUSINESS SUCCESSION

Inheritance Tax (IHT) is often described as a "voluntary tax." This does not mean you can simply choose not to pay it; rather, it means that with careful and early planning, its impact can be legally minimised or even eliminated. For business owners, the potential for IHT to force the sale of a family business to pay a tax bill is a primary concern. This chapter focuses on the most powerful relief available to prevent this: Business Property Relief (BPR). For a solicitor, advising on BPR is a critical skill that allows you to help clients preserve their legacy and ensure the smooth transition of a business to the next generation.

7.1 Introduction to Inheritance Tax (IHT): The Charge to Tax on Death and Lifetime Transfers

Inheritance Tax is fundamentally a tax on the transfer of wealth from one generation to the next. While it's most commonly associated with the estate left behind when someone dies, its reach extends to certain gifts made during an individual's lifetime. Understanding IHT is crucial for any solicitor involved in estate planning, will drafting, or business succession, as failure to plan can result in a significant tax burden that could have been legally mitigated.

The Core Principles of IHT

The operation of IHT rests on three fundamental pillars: the estate, the Nil-Rate Band, and the rate of tax.

1. **The Estate**

    For IHT purposes, an estate includes virtually everything a person owns at the moment of their death. This is a comprehensive concept that encompasses:

- Real property: Houses, flats, land, and other buildings.
- Financial assets: Money in bank accounts, stocks, shares, and other investments.
- Personal possessions: Cars, jewellery, artwork, furniture, and collectibles.
- Business interests: Ownership of a sole trader business, partnership share, or shares in a company.
- Life insurance policies (unless written in trust appropriately).

It is crucial to understand that the estate is valued at its open market value at the date of death, not necessarily what the person originally paid for the assets.

2. **The Nil-Rate Band (NRB)**

    The Nil-Rate Band is essentially the IHT equivalent of a personal allowance. It represents the amount of an individual's estate that can be passed on completely free of IHT. The current NRB for the year 2024/25 is £325,000.

    Every individual has their own NRB, which is transferable between spouses and civil partners.

3. **The Rate of Tax**

    Any part of the estate that exceeds the available Nil-Rate Band is taxed at a standard rate of 40%.

A Foundational Calculation

Let's consider a straightforward example to illustrate these principles.

John dies in the 2024/25 tax year. He was unmarried, and his estate consists of:

- A house worth £500,000
- Savings and investments of £250,000

- Personal possessions valued at £50,000

Total Estate Value: £800,000

He has not made any lifetime gifts that are subject to IHT.

The IHT calculation is as follows:

- Estate Value: £800,000
- Less: John's Nil-Rate Band: (£325,000)
- Taxable Estate: £475,000

The IHT due: £475,000 x 40% = £190,000

This simple calculation reveals the potentially severe impact of IHT. The executors of John's will must find £190,000 in cash to pay HMRC before the remainder of the estate can be distributed to his beneficiaries. For a business owner, where wealth is often tied up in illiquid assets like company shares or property, finding such a large sum could force a fire sale of the business itself. This stark reality underscores the critical importance of the various reliefs and exemptions available within the IHT system.

7.2 A Comprehensive Guide to IHT Reliefs and Exemptions

7.2.1 Introduction to IHT Planning Strategy

The UK's Inheritance Tax framework represents a sophisticated balancing act between revenue collection and social policy. While the headline 40% rate appears daunting, Parliament has created numerous reliefs and exemptions that reflect important societal values: protecting the family home, encouraging lifetime giving, supporting charitable causes, and preserving family businesses. For solicitors, mastery of these provisions transforms IHT from an inevitable burden into a manageable aspect of comprehensive estate planning.

The most effective IHT planning requires understanding how different reliefs interact and developing strategies that combine multiple approaches. This section provides an in-depth analysis of each major relief, with practical examples demonstrating their application in real-world scenarios.

1. The Spouse/Civil Partner Exemption: The Foundation of Family Wealth Transfer

The spouse exemption serves as the cornerstone of most estate plans, providing unlimited transfers between UK-domiciled spouses and civil partners. This exemption recognises the economic unity of married couples and civil partnerships, allowing them to be treated as a single economic unit for wealth transfer purposes.

The transferable nil-rate band mechanism represents one of the most significant planning opportunities in IHT. When the first spouse dies, the percentage of their nil-rate band that wasn't used is preserved and transferred to the surviving spouse. This system automatically adjusts for changes in the nil-rate band over time, ensuring that the combined allowance reflects current thresholds.

Advanced Planning Considerations

- **Will drafting techniques**: For larger estates, solicitors often recommend "nil-rate band discretionary trusts" in wills. This involves leaving an amount equal to the nil-rate band to a trust rather than directly to the spouse, potentially preserving the allowance while still providing for the surviving spouse.
- **Domicile issues**: The unlimited spouse exemption only applies if both spouses are UK-domiciled. If the receiving spouse is non-UK domiciled, the exemption is limited to £325,000 unless an election is made to be treated as UK-domiciled for IHT purposes.

Example: Complex Family Situation

The Thompson family illustrates sophisticated spouse exemption planning. James Thompson dies in 2020 with an estate of £800,000. His will creates a nil-rate band discretionary trust of £325,000 (the threshold at that time).

The remaining £475,000 passes to his wife, Eleanor, under the spouse exemption. Eleanor dies in 2024 with an estate valued at £1,200,000

The available nil-rate bands:

Eleanor's own NRB: £325,000

James's unused NRB: 100% of £325,000 = £325,000

Total NRB: £650,000

IHT Calculation

- Estate value: £1,200,000
- Less total NRB: (£650,000)
- Taxable estate: £550,000

IHT due: £550,000 × 40% = £220,000

Without the nil-rate band trust and transfer mechanism, the tax would have been substantially higher, demonstrating the value of proper will structuring.

2. **The Residence Nil-Rate Band (RNRB): Protecting the Family Home**

Technical Requirements and Conditions

The RNRB introduces complexity through its specific qualifying conditions:

- The property must have been occupied as a residence at some point by the deceased.
- It must be included in the estate immediately before death.
- It must be inherited by direct descendants (children, grandchildren, step-children, adopted children, foster children, or their spouses).
- The allowance is limited to one residential property, but executors can choose which property qualifies.

Tapering Provisions

For estates valued above £2 million, the RNRB tapers away at a rate of £1 for every £2 over the threshold. This creates effective marginal tax rates of up to 60% for estates in the tapering zone, requiring careful planning for high-net-worth individuals.

Downsizing Provisions

Recognising that many people downsize in later life, complex rules allow the RNRB to be preserved when someone sells their home, provided:

- They owned a home on or after 8 July 2015 that would have qualified.
- They leave at least some assets to direct descendants.
- The claim is made within two years of death.

Example: Downsizing Scenario

Margaret, a widow, owned a family home worth £500,000. In 2022, she sold it and moved to a flat costing £300,000, using the £200,000 difference for living expenses. She dies in 2024 with an estate of £900,000, including the flat worth £350,000, leaving everything to her daughter.

RNRB Calculation

- Value of former home: £500,000
- Value of current home: £350,000
- Lower of these values: £350,000
- Maximum RNRB available: £175,000

Actual RNRB: (£350,000 ÷ £500,000) × £175,000 = £122,500

This demonstrates how the downsizing provisions work to preserve some RNRB even when the family home has been sold.

3. **The Annual Exemption: Systematic Lifetime Giving**

Strategic Implementation

The annual exemption enables systematic, tax-efficient wealth transfer through regular gifts. Sophisticated planning involves:

- **Consistent pattern**: Establishing a regular pattern of giving that can be demonstrated to HMRC.
- **Documentation**: Keeping clear records of all gifts and exemptions used.
- **Combination with other reliefs**: Using the annual exemption alongside other strategies.

Carry-Forward Mechanism

The ability to carry forward one year's unused exemption provides flexibility but requires careful tracking. This is particularly useful for individuals with irregular income patterns who may wish to make larger gifts in prosperous years.

Example: Multi-Year Annual Exemption Planning

The Chen family demonstrates strategic use of annual exemptions:

2022: Mr. Chen gives £2,000 to his son (leaving £1,000 unused)

2023: He gives nothing (carrying forward £1,000 from 2022)

2024: He gives £5,000 to his daughter

Exemptions applied:

- 2024 annual exemption: £3,000
- 2023 carried forward: £1,000
- 2022 carried forward: £1,000 (total £5,000)

The result is that the entire £5,000 gift is exempt

This shows how careful planning over multiple years can facilitate larger tax-free transfers.

4. Gifts Out of Normal Expenditure: The Overlooked Workhorse

Establishing the Pattern

This exemption requires demonstrating a settled pattern of giving from income. Key factors considered by HMRC include:

- **Regularity**: The gifts should form part of the donor's regular expenditure.
- **Income sufficiency**: The donor must retain sufficient income to maintain their normal standard of living.
- **Intent**: The pattern should be established rather than being a one-off occurrence.

Documentation Requirements

Successful claims require robust evidence, including:

- Bank statements showing regular transfers.
- Documentation of the income source.
- Evidence that living standards were maintained.

Example: Business Owner's Expenditure

Charles, a company director with annual income of £200,000, has for eight years:

- Paid £20,000 annually toward his grandchildren's school fees.
- Given £15,000 annually to his children.
- Maintained his lifestyle in a £800,000 home with regular holidays.

Analysis

- The established pattern qualifies as normal expenditure
- His substantial income clearly supports these gifts without affecting his lifestyle

The result is that £35,000 annually is exempt from IHT, potentially removing £280,000 from his estate over eight years

5. **Small Gifts and Marriage Exemptions: The Supplementary Tools**

Strategic Use of Small Gifts

While individually small, the £250 per person exemption can be valuable for:

- Regular gifts to multiple grandchildren.
- Birthday and Christmas presents to extended family.
- Small gestures to employees or carers.

Marriage Gift Planning

The enhanced exemptions for marriage gifts provide opportunities for significant tax-free transfers during family milestones. Planning might involve:

- Timing larger gifts to coincide with marriages.

- Coordinating gifts from multiple family members.
- Documenting the connection to the marriage.

6. Potentially Exempt Transfers (PETs): The Core of Lifetime Planning

The Seven-Year Timeline

PET planning requires understanding the complex interaction with the nil-rate band and the potential for taper relief:

Years Survived After Gift	Tax Rate
0-3 years	40%
3-4 years	32%
4-5 years	24%
5-6 years	16%
6-7 years	8%
7+ years	0%

The 14-Year Rule

When multiple gifts are made, a complex 14-year rule applies, where gifts made within seven years before death can affect the tax on earlier gifts. This requires careful sequencing of larger transfers.

PET Example: Business Succession

The Wilkinson family business succession plan:

2018: Mr. Wilkinson gifts 30% of his company shares worth £200,000 to his daughter

2020: He gifts another 30% worth £250,000

2023: He dies with an estate of £800,000

Analysis

- The 2018 gift is more than 5 years before death: tax rate 16%.
- The 2020 gift is 3-4 years before death: tax rate 32%.
- Tax calculations:
  - 2018 gift: £200,000 × 16% = £32,000.
  - 2020 gift: £250,000 × 32% = £80,000.
- Total PET tax: £112,000

This demonstrates the importance of timing in PET planning and the value of making gifts early.

7. Charitable Giving: Philanthropy with Tax Benefits

The 10% Reduction Strategy

Leaving at least 10% of the net estate to charity reduces the IHT rate from 40% to 36%, creating interesting planning opportunities:

Example: Charitable Will Planning

George has an estate of £2,000,000 after all exemptions. He considers leaving different amounts to charity:

Scenario A: No charitable gift

IHT: £2,000,000 × 40% = £800,000

Family receives: £1,200,000

Scenario B: £200,000 to charity (10% of net estate)

IHT: £1,800,000 × 36% = £648,000

Charity receives: £200,000

Family receives: £1,152,000

Scenario C: £500,000 to charity

IHT: £1,500,000 × 36% = £540,000

Charity receives: £500,000

Family receives: £960,000

This analysis helps clients balance philanthropic intentions with family provision.

Combining Multiple Reliefs

The Holistic Approach

The most effective IHT planning combines multiple reliefs in a coordinated strategy.

Case Study

Robert and Susan, both 65, have:

- Family home: £750,000
- Investments: £600,000
- Robert's business: £400,000
- Pensions: £300,000

Their integrated plan:

1. Wills: Structure to utilise both NRBs and RNRBs
2. Annual giving: £3,000 each to their two children annually
3. Normal expenditure: £20,000 annually from Susan's inheritance to pay school fees
4. PETs: Gift business shares to children using Business Property Relief
5. Pensions: Designate pensions to bypass the estate

Projected 20-year outcome:

- Potential estate reduction of £1.2 million through systematic planning.
- Business assets protected through BPR.
- Family wealth transferred efficiently across generations.

Effective IHT planning requires:

- Early intervention: Beginning the planning process well before retirement.
- Regular review: Updating plans as circumstances and legislation change.
- Holistic approach: Considering all assets and reliefs together.
- Documentation: Maintaining clear records of all planning steps.
- Family communication: Ensuring beneficiaries understand the plan

The sophisticated interplay between different reliefs means that solicitors must approach IHT planning as a dynamic process rather than a one-time exercise. By understanding how the various exemptions complement and interact with each other, practitioners can develop robust strategies that preserve family wealth while remaining fully compliant with the legal framework.

The transition to Business Property Relief in the next section represents a specialist application of these principles, demonstrating how business assets require particular consideration within the overall estate planning context. The fundamental understanding of general IHT reliefs provides the essential foundation for tackling the complex but rewarding area of business succession planning.

7.2 Business Property Relief (BPR)

7.2.1 Rationale and Purpose of BPR

The purpose of BPR is to protect trading businesses from being broken up or sold simply to pay an IHT bill. The government recognises that businesses provide employment, drive economic growth, and are often the life's work of an individual. BPR encourages entrepreneurship and allows businesses to be passed down through generations.

The Effect: If an asset qualifies for BPR, its value can be reduced by 50% or 100% when calculating the value of the estate for IHT. In many cases, this reduces the IHT bill to zero.

7.2.2 Qualifying Business Property: Shares vs. Assets

BPR applies to specific types of business property. The two most important categories for a business owner are:

1. A business or an interest in a business (e.g., a sole trader's business or a partner's share in a partnership). This qualifies for 100% relief.

2. Shares in an unlisted company (e.g., shares in a family 'Ltd' company). This qualifies for 100% relief.

3. Shares in a listed company that give the shareholder control (over 50% of the voting rights). This qualifies for 50% relief.

Key distinction: The relief attaches to the property (the business asset or the shares), not the person. The ownership period and the nature of the business are what matter.

7.2.3 Conditions for Relief: The "Relevant Business Property" Test

To qualify, the business property must meet two key tests:

1. **The ownership test**: The person must have owned the business property for at least two years before the transfer (either on death or as a gift). This prevents last-minute purchases simply to avoid IHT.

2. **The trading business test**: The relief is only available for businesses that are primarily involved in trading. The business must not consist wholly or mainly of dealing in securities, stocks, shares, land, or buildings. This is designed to exclude investment activities.

7.2.4 Rates of Relief: 100% vs. 50%

The rate of relief depends on the type of property, as mentioned above.

Example 1: 100% Relief for an Unlisted Company Shareholder

Sarah owns 75% of "Sarah's Software Ltd.", an unlisted company. She has owned the shares for 10 years. On her death, her shares are worth £1,000,000.

Because the shares are in an unlisted trading company and she has owned them for more than two years, they qualify for 100% BPR.

The result is that the entire £1,000,000 is deducted from the value of her estate. No IHT is payable on this business wealth.

Example 2: 50% Relief for a Controlling Shareholder in a Listed Company

David owns 51% of "UK Manufacturing PLC", a company listed on the stock exchange. He has owned the shares for 5 years. On his death, his shareholding is worth £2,000,000.

Because he has control of a listed company, the shares qualify for BPR, but only at the 50% rate.

Calculation

- Value of shares: £2,000,000
- BPR (50%): £1,000,000
- Value added to estate: £2,000,000 - £1,000,000 = £1,000,000

Result: £1,000,000 of the share value is potentially subject to IHT.

7.2.5 Excluded Activities: Investment Businesses and Excepted Assets

This is a critical anti-avoidance measure. BPR is not a gift to all business owners; it is specifically for those who are trading.

Excluded activities: A business is not qualifying if it consists "wholly or mainly" of one of the following:

- Dealing in securities, stocks, or shares (e.g., a stockbroker).
- Dealing in land or buildings (e.g., a property developer).
- Making or holding investments (e.g., a company that only owns rental properties).

Example: The Property Company

Mr. Jones owns "Jones Holdings Ltd.". The company's only asset is an office block that it rents out to tenants. The company's activity is receiving rent.

Analysis: This is an investment business. It does not qualify for BPR.

Result: On Mr. Jones's death, the full value of his shares will be subject to IHT.

Excepted assets: Even within a trading company, not all assets may qualify. If a company holds assets not required for future use in the trade (e.g., a large amount of cash not needed for working capital, or a second property used as an investment), the value of these "excepted assets" may be stripped out and denied relief.

7.3 Integrating IHT and BPR into Business and Estate Planning

A solicitor's role is to weave BPR into a coherent strategy for the client.

Key Planning Point: Gifting Business Assets

BPR applies not only on death but also to lifetime gifts. This means a business owner can gift shares in their trading company to their children during their lifetime, and if they survive for a further seven years, the gift falls out of their estate completely. Even if they die within seven years, the gift will still qualify for BPR, provided the conditions are met, and no IHT will be due.

Example: The Lifetime Gift of Shares

Robert, aged 70, owns 100% of "Robert's Engineering Ltd.", worth £1,000,000. He wants to pass the business to his daughter, Emily. Robert gifts all his shares to Emily today.

IHT Implications:

This is a "Potentially Exempt Transfer" (PET).

If Robert survives for 7 years from the date of the gift, the £1,000,000 is completely out of his estate for IHT purposes.

If Robert dies within 7 years, the gift becomes chargeable. However, because the shares qualify for 100% BPR (assuming all conditions are met), the value of the gift is reduced to £0 for IHT calculations.

Result: Whether Robert lives 7 years or not, the business passes to Emily free of IHT. This is a very powerful strategy.

7.4 Interaction of BPR with Other Taxes (CGT, Income Tax)

Taxes do not exist in a vacuum. A decision made to save IHT can trigger another tax. A solicitor must consider the whole picture.

Interaction with Capital Gains Tax (CGT)

When you give an asset away during your lifetime, it is treated for CGT as a disposal at market value. This can create an immediate CGT bill, even though no cash is received.

Example: The CGT Trap

Using the previous example, when Robert gifts his shares to Emily, it is a disposal for CGT. He originally bought the shares for £100,000. They are now worth £1,000,000.

His chargeable gain is £900,000. He may be able to claim Business Asset Disposal Relief (BADR), reducing the CGT rate to 10%.

CGT due: £900,000 x 10% = £90,000.

Advice: Robert must have £90,000 in cash outside the business to pay this tax. If he doesn't, the plan may be unworkable. An alternative could be to gift the shares in stages to use his annual CGT exemption, or for Emily to pay the tax from company funds if structured correctly.

Interaction with Income Tax (Dividend Tax)

If the children receiving the business (the new shareholders) start extracting profits as dividends, they will pay Dividend Tax. The IHT saving must be weighed against the potential for higher ongoing income tax if the children are higher-rate taxpayers.

7.5 Conclusion

Inheritance Tax (IHT) poses a significant threat to the continuity of family businesses, with its 40% rate on estates exceeding £325,000 potentially undermining years of growth and succession planning. Business Property Relief (BPR) serves as the primary safeguard, offering up to full exemption on qualifying business assets provided that key conditions, such as a minimum two-year ownership and active trading status, are met.

However, effective use of BPR requires careful, forward-looking planning. Whether applied to lifetime transfers or on death, advisers must approach IHT strategies holistically, mindful of the interplay with other taxes such as Capital Gains Tax (CGT). Ultimately, sound legal and tax planning should balance preservation of the business with fiscal prudence, ensuring that family enterprises transition smoothly across generations without creating new tax liabilities in the process.

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- Advise on Business Structures authoritatively, comparing the tax implications for sole traders, partnerships, and limited companies to help clients make informed choices.
- Apply Key Reliefs and Exemptions strategically, utilising powerful tools like Business Asset Disposal Relief (BADR) and Business Property Relief (BPR) to achieve optimal client outcomes.
- Distinguish Between Planning, Avoidance, and Evasion, understanding the ethical boundaries, the General Anti-Abuse Rule (GAAR), and your professional duties.
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