

UK: The new 50% income tax rate woes

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The new 50 percent tax rate, which has come into force in the UK since April 06 this year has created much unrest amongst the high earning taxpayers. Julie Butler examines the impact of this increased burden on taxpayers, with specific focus on the position of legal practitioners, particularly barristers.

I. Introduction

Every UK higher rate taxpayer needs to take a close look at the impact of the forthcoming 50 percent income tax rates. From April 6, 2010 there will be a 50 percent tax rate of income over GBP150,000. In addition, the personal allowance will be abated for income between GBP100,000 and GBP112,950. There will be major concerns for taxpayers where there are large income and profit swings which can go above and below the GBP100,000 limit. There could be years when the full 40 percent rate will not be used and other years when the heavy 50 percent tax rate will be extremely burdensome. The irritation of the abated personal rate will also be a clear problem in the years of fluctuation of profit. Examples of those categories of taxpayers who will suffer are barristers, medical professionals, self-employed HR, IT and management consultants etc. All small businesses with projected profits of over GBP100,000 will be vulnerable. Is incorporation the answer?

II. The choice of the limited company

Looking ahead to April 6, 2010, an interesting set of choices will arise depending on whether someone is a higher rate taxpayer or even a new "super higher rate" taxpayer from 2011. From 2010, the owner of a small business who earns over GBP100,000 will see his or her personal allowance being tapered away until he or she reaches GBP112,950 when the personal allowance will disappear entirely. The rate of National Insurance Contribution (NIC) is also increasing by 0.5 percent from 2011.

The tax adviser, therefore, has to build into current tax planning, the opportunity of paying 40 percent tax now before the increase in tax rates, i.e. in the year to April 5, 2011 and onwards, and to maximise dividends at 40 percent whilst it can be enjoyed. Could this be achieved by paying dividends now?

In a fairly recent case, *Paycheck Services No 3 Limited, Revenue & Customs Commissions v Holland* (2008) All ER(D) 319 (June 24, 2008), the respondents were directors of Paycheck Service No 3 Limited (PS) which they operated as their trading company. The directors each held 50 percent of the issued shared capital. PS Limited itself held 100 percent of the issued shared capital of PDS Limited and PSS Limited and the respondents were each appointed as directors of PDS and PSS. All three companies, together known as the composite companies, relied on an extra statutory concession in relation to the calculation of corporation tax.

In April 2001, Revenue & Customs claimed that the composite companies might not be entitled to rely on the extra statutory concession. While the respondents took legal advice, they were never advised that the composite companies should stop paying dividends. The Revenue subsequently commenced proceedings against the respondents, seeking to make them responsible to meet further liability for higher rate of corporation tax payable by the composite companies. The Revenue's case was that by causing the composite companies to continue to trade and pay dividends, with knowledge that the composite companies were then rendered insolvent given the additional tax liability.

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ity, the respondents were in breach of their duties as directors, i.e., they could not pay illegal dividends.

The Judge held that from the time, the directors received legal advice about the tax position, there was no reasonably held belief that the Revenue's claims to additional corporation tax would be defeated and accordingly, from that date onwards, the interim accounts ought to have made provision for the additional tax liability. In the circumstances, any dividends paid after that date had been unlawful and were liable to be repaid. Prior to receiving legal advice, there were reasonable grounds for the continuation of payment of dividends. However, once the liability was known, dividends should have stopped.

The fine balance between tax planning, directors' duties and cash flow management is made clear by tax planning to avoid the "super higher rate of tax" as emphasised by cash flow management and prudence together with the risk of trading insolvently in this case.

There are many tax planning opportunities and the timing of dividends is key but one must also be cautious about the possible unlawful dividend.

Let us use barristers as an example; there are problems of the calculation of work in progress (WIP) under UITF 40 and the problems of the long term nature of a lot of the work – the need for "professional judgement". There are problems of debt collection and bad debts which needs provision in the accounts.

III. The value of work in progress and UITF40

There will be many professionals and small businesses that will try and keep within the GBP100, 000 or GBP150, 000 profit levels by the "imaginative" valuation of work in progress. How easy it would be to start with the desired profit and then work back to adjust work in progress figures. The rules that guide barristers are a good example for professionals to follow as they take the UITF 40 guideline a stage further specific to the profession. Will all professional bodies have to give specific guidelines as to how work in progress should be valued? Will each profession give clear examples on time recording etc.?

The Tax Faculty of the ICAEW (Institute of Chartered Accountants in England and Wales) issues *Taxguide 5/06: Guidance Notes on the Tax Aspects of UITF Abstract 40* in July 2006. There was additional guidance from the ICAEW Tax Faculty on October 2, 2006 *Taxguide 8/06: UITF 40 and Taxation* (this guidance has been agreed by HMRC). The bottom line was that all professionals in practice can no longer ignore all 'work-in-progress' regardless of the circumstances. This will result in accelerated income, profit and tax. The Bar Council published guidance on the application of UITF 40 to barristers in May 2006.

Although the guidance published by the ICAEW is designed primarily to assist small businesses, it applies to all service providers who are affected by UITF 40. The guidance applies to UITF 40 only and does not address the application of comparable requirements in either FRSSE (the *Financial Reporting Standard for*

Smaller Enterprises) or in International Financial Reporting Standards. It does affect all high earning professionals who need to value work in progress.

The detail of UITF 40 begins with a Statement of Standard Accounting Practice, SSAP 9 *Stocks and Long-Term Contracts*, and a Financial Reporting Standard, FRS 5 *Reporting the Substance of Transactions: Revenue Recognition*. The latter was supplemented by an Application Note G *Revenue Recognition* (in accountancy shorthand, FRS 5 ANG), which made general rules for recognition of revenue. It introduced the notion that revenue should be recognised when the seller has a 'right to consideration'. UITF 40 interprets FRS 5 ANG.

IV. Prudent estimate: The problem of uncertainty

Generally, if there is uncertainty about the amount that will be earned, the professional should make a prudent estimate of the recognisable revenue. If in a rare case no reliable estimate can be made, revenue should not be recognised at all.

The Bar Council's current guidance on the application of UITF 40 to the computation of barrister's earnings, issued in May 2006, was an update of an earlier Guidance Note published on March 10, 1999 ('the 1999 Guidance'). There is uncertainty surrounding all professionals – timely accounts can use this to advantage.

V. Contract activity v. contract completion

Two principles predominate under the rules:

- Contract activity rather than contract completion or invoicing is the focus of revenue recognition; and
- When work is partly performed at the end of the barrister's accounting period, the fair value of the right to consideration earned should be brought into the accounts as revenue.

If, in any particular case or matter, by the end of the accounting period, work has been performed for which a barrister has 'obtained a right to consideration', then under UITF 40, that work should be taken into account in the same way and to the same extent as 'completed work', as explained in paragraphs 9 to 12 of the 1999 guidance.

Again this basic principle will apply to all professionals having to value work in progress. How tempting it is to undervalue work in progress rather than "pay tax on monies not yet received."

VI. The need for professional judgement

Work completed at the end of the barrister's accounting period must be brought into account as debtors, in the amount of the agreed or anticipated fee (the latter may necessitate professional judgement). In the case of incomplete work, which straddles the end of the barrister's accounting period, it is necessary to bring in a reasonable estimate of the fee earned as a result of the work done by that date. All of the above is sub-

ject to the 'materiality concept' referred to in paragraphs 4 to 6 of the 1999 guidance.

There is no doubt that objectivity could be threatened by the difference between 40 percent and 50 percent tax or the loss of personal allowances. This will apply to all self-employed professionals – accounts preparation with regard to debtors and work in progress always requires professional judgement.

VII. Barrister in the first years

The UITF 40 changes do not affect barristers in their first seven years of practice, who may continue to use a cash basis for tax purposes. How are the seven years defined? They run from the time barristers start 'holding themselves out' for fee-earning work.

At the end of the seven years, the barrister must comply with UK GAAP (Generally Accepted Accounting Practice) and bring into account most debtors and UITF 40. These can be spread forward under the existing ten-year provision.

VIII. The Bar Council's guidance

So what guidance does the Bar Council give in specific circumstances? The notes published in May 2006, *Application of UITF 40 to Barristers' Earnings*, say that:

A. No win, no fee

Revenue should not be recognised until the case has been won. Only at that stage does the barrister have a right to any consideration (UITF 40, paragraph 27).

B. Pay at end

The fee is not agreed in advance, nor is the rate fixed. Instead, the consideration is negotiated at the conclusion of the case. The difference from 'no win, no fee' is that a fee will always be due. Before UITF 40, this was included as soon as the fee was negotiated.

There is significant uncertainty about the amount of the fee that has been earned by an accounting date prior to the end of the case. Nevertheless, it is clear that the relevant fee is not nil. Under UITF 40 there are two possible arguments:

- Where there is some uncertainty about the fee but a reasonable estimate can be made, at least of the minimum that will be earned, then an estimate should be made of the proportion of the total fee that has been earned as a result of work done by the accounting date. This estimated amount should be included as revenue.
- Where there is genuinely so much uncertainty that no reliable estimate can be made of the total fee and of the part of that total that has been earned to date, no revenue should be recognised until such time as the uncertainty has reduced and a reliable estimate

can be made. This might be at a later stage of the case or it might not be until the fee is negotiated at the end of the case, depending on the facts and circumstances. However, there is a general assumption that amounts can be estimated with sufficient reliability to be included in financial statements. Accordingly, non-recognition due to an amount not being reliably estimable should be very much the exception.

C. Fixed fee cases

A barrister works on certain types of publicly funded cases ('cost assessed', 'graduated fee' and 'prosecution'). These cases are conducted for a fixed fee. Before UITF 40, revenue was recognised on completion of the case. Is it right to say that UITF 40 can be read to give the same result? Another view appears to be that every case on which the barrister is working should be examined and that the proportion of the consideration which had accrued by the year-end should be included, even though there is as yet no right to that consideration. A further reason why one might argue that this is incorrect is that if the barrister who has prepared the case is unable to present it in Court, then the barrister presenting the case receives

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the whole of the fee.

The Bar Council advises that the appropriate accounting here is a matter of professional judgement depending on the facts of the situation. If the fee was agreed but the amount of remaining work and therefore time to be spent was open-ended and therefore very difficult to predict, one would either:

- Recognise some revenue but on the basis of a very conservative estimate; or
- Argue that no reliable estimate can be made until the case is further progressed.

As to the point about potentially losing the fee if the barrister cannot appear in Court, the effect of this point on the accounting depends on the substance. If losing the fee due to being unable to present the case in Court is rare, one would either disregard it or make an overall reduction of a few percentage points in the overall revenue figure to allow for the rare case in that category. If it is common that a barrister prepares a case and is not able to present it, thereby losing the fee, it may be that there is no sufficient certainty to justify recognition of revenue until the barrister does present the case in Court and is thereby assured of receiving the fee. Events after the accounting date (appearing or not being able to appear in Court) may of course reduce the uncertainty in some cases.

These rules will also apply to other professionals working on fixed fee contracts and give good guidance for all professionals producing accounts.

D. Legal aid cases

Legal aid in some cases is not agreed until after the matter has been settled. In lengthy cases, payments on account are made. This is a long and protracted procedure that can take many years. Often the payments on account will be for a greater amount than the eventually agreed fee and the barrister has to return the excess. Hitherto, it has been agreed with HMRC that the relevant tax point is payment, normally a payment on account, or the agreement of the fee, whichever comes first.

Again, under UITF 40 professional judgement has to be applied here and the accounting treatment will depend on the degree of uncertainty. In principle, revenue should be recognised according to the work done to date, rather than according to progress payments received. If a reasonable estimate can be made of the revenue that has been earned as a result of the work done to date, then that should be recognised. Prudence should be built into that estimate, in response to the uncertainty. It may be that the level of uncertainty is so high that no reliable estimate can be made until either later in the process or until the case is completed and the fee agreed. Finally, a barrister should not recognise all the progress payments received as revenue, even if they do bear a close relationship to the work done to date, if it is likely that some of the amounts received will have to be refunded.

Clearly the key is professional judgement and there will be uncertainty. The basic accounting principles and rules must be applied here – for example, consistency, and prudence where there could be refunds of fees already received. It is important to establish and document a policy, and to ensure that it is consistently applied with clarity, with an ‘audit trail’ of working papers that could be used to demonstrate that a reasonable policy has been carefully applied.

There may be a temptation for barristers to exaggerate the element of uncertainty and the need for professional judgement on questions of revenue recognition – and, conversely, for tax inspectors to underrate that uncertainty. Such difficulties can be minimised by the barrister establishing a clear revenue recognition policy and keeping the records necessary to show that it has been consistently applied.

IX. Action plan for all worried taxpayers

A. Short-term planning: 2010/2011

If the 50 percent rate looms in 2010/11 then try to legitimately include as much in 2009/10 as possible and “bank” the 40 percent. However, if borrowings have to be obtained to pay for the 40 percent now it could be argued that this is marginal compared to the 10 percent tax saving. It will be essential to produce draft accounts and forecasts *now* to review the position.

B. Medium-term planning

As mentioned, objectivity will be a problem. However, where there is uncertainty about both work-in-progress (WIP) and debtors, if the accounts are approved and signed as soon as possible, it can be argued that the greater uncertainty could mean a more prudent approach to WIP and debtors. However, if the accounts are finalised a long time after the year end there will be more certainty. This applies to all self-employed taxpayers troubled by the 50 percent rate.

The date of approval of accounts and tax returns might become a tax planning tool for barristers. However, the questions must be asked – barristers producing accounts in a timely manner and working on projections. Has this article been published on 1 April?

X. Produce accounts on time

For all those taxpayers earning amounts approaching GBP100,000 to GBP150,000 it will be essential to produce management accounts during 2010/11, timely final accounts, and to plan ahead in a professional manner.

The same principles apply to all professionals. It will be very simple to manipulate accounts to try to avoid the 50 percent rate by planning the timing of invoices, being prudent with the valuation of work in progress and choosing the timing of the writing off of bad debts. The reality of this is that HMRC are alive to these potential actions and innocent or planned protection of the avoidance of the 50 percent rate must be well documented, justifiable and be able to demonstrate good faith throughout.

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