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CHARTERED ACCOUNTANTS

Shared experience.

Buzzacott's Professional Practices Group

Spring 2017 Newsletter

In this edition

DIVIDEND ALLOWANCE + CGT ALLOWANCE = "TAX FREE PORTFOLIO"

The taxation of dividends was changed from 6 April 2016, primarily to prevent people reducing their tax bill by setting up a company, paying Corporation Tax on profits and then taking income as dividends.

The reforms abolished the old 10% tax credit on dividends and introduced the dividend allowance, whereby the first £5,000 of dividend income is tax free.

This change has potentially been disadvantageous for individuals who:

- Are able to pay themselves dividends in place of wages;
- Have significant dividend income; and
- Have previously avoided the tax charge up until now (basic rate taxpayers).

Further changes in the 2017 Budget reduced the £5,000 tax-free allowance to £2,000 from April 2018.

The changes can, however, benefit some particularly higher or additional rate taxpayers with dividend income from investments.

Show me some examples…

Currently, a higher rate taxpayer with a £200,000 portfolio of equity funds with an average yield of 2.5% a year can now receive all their dividend income (£5,000) without a tax charge. Previously, they would have paid 22.5% of the gross dividend or £1,125 in tax. On dividend income above £5,000 (£2,000 from the 2018/19 tax year), higher rate taxpayers pay tax at 32.5% and additional rate taxpayers pay 38.1%.

For an investor with a £200,000 equity fund portfolio, and assuming capital growth of 5% a year, the investor can also take advantage of their Capital Gains Tax (CGT) annual exempt amount (£11,100 for 2016/17 tax year) to re-base their portfolio or withdraw the gains (£10,000). By combining the CGT annual exempt amount and the dividend allowance, an investor effectively has a £200,000 'tax-free' portfolio.

This amount reduces to £80,000 (assuming a 2.5% dividend yield) from the 2018/19 tax year when the allowance decreases from £5,000 to £2,000. Notwithstanding this, it will remain useful for those having already fully utilised tax-efficient ISAs or pension allowances.

Got some questions?

For further information, please contact Buzzacott's Financial Planning team.

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THE ART OF VALUE

Ask any business owner what their business is worth and they will confidently be able to provide a figure. But, when you delve a little deeper they may be hard pressed to defend why.

Value is crucial to any business and we would argue that, for many, valuation is the single most important KPI. Yet it is rarely measured properly.

Value determines what a shareholder can expect for each of their shares and it helps the owners and managers make decisions about the future – should they invest, should they sell? It can also help incentivise staff, guiding them to build value in business, not just profits.

The problem with calculating the value of a business is there is no simple formula. Even two experts may come up with differing values for the same company.

So what is value?

At its core, valuation is determined by a market of buyers and sellers. For quoted companies whose shares can be bought or sold on the Stock Exchange, valuation is easier as there is an open traded market on which shares are purchased and sold and the prices at which the shares are traded can be easily tracked. For private companies, this market doesn't exist. Often there may be no historic share transactions within the company, leaving no trail or point of reference. In this instance the aim is to judge how much an acquirer would be willing to pay for your business.

How do you calculate value?

To be able to calculate value we need to think about what is actually being valued – which is simply the future cash flows of the business less any liabilities plus all assets.

If the business isn't generating positive cash flows, net asset value (i.e. the current balance sheet) will give a view of how much the business could be worth if all its components were sold individually. However, most businesses do generate cash from their assets and the balance sheet takes no account of how much value the business is generating from those components.

Discounted cash flow is the value of future cash flows discounted back to today's value. The further out the cash flow, the more it is discounted due to uncertainty related to it. As a method of calculation it is heavily reliant on the assumptions that underpin the future cash flow, as a change to these assumptions could have a large impact on the current value.

Earnings multiples – typically P/E ratios or EBIT or EBITDA multiples – concentrate on current results compared to the market. The calculation looks at the multiples of a business's profit to determine its value. This is effectively an approximation for discounted cash flow. This method still adds in subjectivity over what the correct multiple is for profit. And, of course, the whole model breaks down if a business is loss-making as is often the case with young, high-growth firms, even if they expect to be profitable soon.

Each of these methods (and others) can produce a wide range of values. At the end of the day valuation is an art, not a science. The key to valuation is to logically look at the arguments and build a coherent case as to why a particular method and value are fair. This is where having experts can really help, using their experience and technical knowledge to be able to argue on your behalf.

LAW FIRMS: COFA HANDY HINTS

The role of the Compliance Officer for Finance and Administration (COFA) is an integral part of outcomes-focused regulation. Expected to be champions of risk management and compliance within a firm, the requirement for a COFA role was introduced from 1 January 2013. But what are the intricacies of a COFA's role? Take a look:

A COFA must be an individual who:

- Is an employee or manager of the practice;
- Is of sufficient seniority and in a position of sufficient responsibility to fulfil the role;
- Is approved by the SRA for that role; and
- Has consented to undertake the role.

A firm's COFA is required to:

- Ensure compliance with the SRA Accounts rules;
- Keep a record of any failure to comply (i.e. maintain a breaches log); and
- Report to the SRA promptly any material failure to comply.

In order to be in a position to execute the role, the COFA should:

- Have access to the firm's accounting records;
- Carry out regular checks on the accounting systems;
- Carry out file and ledger reviews;
- Ensure any breaches of the rules are remedied promptly; and
- Monitor, review and manage risks to compliance.

WHAT TOP 5 THINGS SHOULD A COFA LOOK AT?

1. Ensuring all payments from the client account are authorised. There should be an appropriate system in place for this ensuring segregation of duties with, ideally, a different person setting up the payments from those authorising payments.
2. Reviewing monthly three-way bank reconciliations. Standard bank reconciliations compare the bank statement balance against the balance in the accounting records. The bank statement balance is adjusted to account for uncleared cheques or lodgements to reach the balance in the accounting records. Law firms must go one step further to ensure the balance in the accounting records also agrees to the total client monies balance according to the client matter ledger.
3. Checking (ideally daily or at a minimum weekly) to make sure there are no overdrawn client ledgers. This is indicated by a 'DR' or negative balance on the client side of the ledger.
4. Reviewing partner drawings to make sure they're not in excess of profits earned.
5. Keeping an eye on lock-up (combined WIP and debtors) and raising a red flag if it seems to be on an upward trend or if the overdraft is consistently at the maximum level.

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IS HMRC ABOUT TO CHALLENGE PARTNERSHIPS?

HMRC has issued its key findings following the consultation to clarify tax treatment for partnerships.

These are:

- The profit stated in the partnership return will remain the reference point for determining a partner's taxable profits. Proposals for partnerships to notify HMRC of profit sharing arrangements have been dropped by HMRC, noting the additional burden this will cause.
- Retrospective changes to partners' profit sharing arrangements made post year-end will not apply. This is to avoid profits being allocated for purely tax motivated purposes.
- HMRC will legislate to ensure that in bare trust/nominee arrangements the beneficial person is named on the partnership return.

Our reading of this is that the sort of partnership model preferred by professional practices is not HMRC's main target and is not being challenged.

Events

From beginning to end…An entrepreneur's story on selling their business

09.05.2017

Join Matt Katz, Buzzacott Corporate Finance Partner, and Julian Bashford who will be sharing his experience of founding, building and exiting Vocality International to NYSE listed Cubic Corporation.

Julian's insights will be invaluable for anyone who is planning on exiting their business in the next few years.

Annual HR employment law update

06.06.2017

Buzzacott's annual essential employment law update provides an overview on all the changes to employment legislation over the past year, discussing the implications for both businesses and charities and offering practical guidance on how best to deal with these changes from an HR perspective.

For more information on the events or to sign up, please contact marketing@buzzacott.co.uk

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