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The Tax Trap of Selling Future Earnings

Rupert Grint, famous for his role as Ron Weasley in the Harry Potter films, recently faced a tax dispute with HMRC over the sale of his future earnings. The case highlights the risks of using complex arrangements to minimise taxes and sheds light on the rules around selling income as a capital asset.

What Happened?

In 2011, Grint formed a company, Clay 10 Ltd, to manage his acting income. The company paid Grint £8.5 million in return for the rights to his:

- **Past acting income** (£4 million) – taxed as regular income.
- **Future acting income** (£4.5 million) – declared as a capital gain, with Grint claiming **entrepreneurs' relief** (now called **business asset disposal relief**). This reduced his tax on the £4.5 million from 45% (income tax) to 10% (capital gains tax).

However, HMRC challenged this setup, arguing that the arrangement was designed to avoid income tax. They applied anti-avoidance rules under **ss 773-789 of the Income Tax Act 2007**, which treat such capital payments as taxable income when the primary motive is tax reduction.

The Tribunal's Decision

The First-tier Tribunal (FTT) ruled in HMRC's favour. Key findings included:

1. The payment of £4.5 million was substantially derived from Grint's acting activities, making it taxable as **miscellaneous income**.
2. Although Grint argued the arrangement was for income protection against family exploitation, the Tribunal determined that **tax reduction** was the "most important object."
3. The income tax charge arose in the **2011/12 tax year**, the year the rights were transferred to the company.

Key Legal Framework

The anti-avoidance rules apply to prevent individuals from converting income into capital to avoid tax. For these rules to be triggered:

1. Another party (e.g., a company) must receive income derived from an individual's work.
2. The individual must receive a **capital sum**, in money or value, as part of the arrangement.
3. The **main motive** of the arrangement must be to reduce or avoid income tax.

Exceptions and Exemptions

The going concern exemption (ss 784-785 ITA 2007) allows for the sale of a business to be taxed as a capital gain if the value reflects the business's fair market value and isn't primarily derived from the individual's activities.

Examples:

1. **Legitimate Sale**: A solicitor sells their practice for £200,000 (fair market value) and continues to work for a commercial salary. Only CGT applies.
2. **Tax Avoidance Challenge**: If the same solicitor inflates the sale price to £300,000 and accepts a nominal salary, the extra £100,000 is treated as income.
3. **Successful Defence**: A surgeon sold their practice, including goodwill and intellectual property, for £1 million. The Tribunal ruled this as a legitimate **business disposal**, despite HMRC's argument that it was disguised income.

Lessons from Grint's Case

Grint's case underscores the importance of having clear, non-tax-driven reasons for transferring income to a company. HMRC rarely applies these rules, but when challenged, the taxpayer must demonstrate that:

- The arrangement wasn't primarily motivated by tax avoidance.
- There is legitimate business rationale, such as protecting intellectual property or improving operational efficiency.

Key Takeaway

Selling future earnings to a company you own can trigger tax challenges under anti-avoidance rules. If you're considering such a move:

- Ensure the arrangement has strong, non-tax reasons.

- Document the rationale thoroughly to support your case if HMRC questions it.
- Seek professional advice to ensure compliance and avoid costly disputes.

Navigating the Changing Tax Rules in 2025

As businesses look ahead to 2025, a range of tax changes is set to create new challenges and opportunities. From higher tax rates on selling a business to adjustments in employment taxes and the phased rollout of **Making Tax Digital (MTD)**, preparing early is key to reducing costs and staying compliant. Looking further ahead, significant changes to **inheritance tax (IHT)** will impact long-term succession planning.

Here's what businesses need to know and how to plan effectively.

Changes to Business Asset Disposal Relief (BADR)

Currently, businesses benefit from a 10% tax rate on the first £1m of qualifying gains when selling a business. However, from 6 April 2025, this rate will rise to 14%, increasing the tax liability on £1m of gains by £40,000.

How This Impacts You:

- **Selling a Business**: If you're planning to sell your business in the next 12–18 months, consider accelerating the transaction to lock in the lower tax rate.
- **Deferred Payments**: If part of your sale involves deferred payments like loan notes (IOUs), new anti-forestalling rules mean the tax rate at the time of election—not when the loan note was received—will apply. Finalising elections by the end of the tax year will be crucial to secure the current 10% rate.
- **Plan Ahead**: Businesses should consult tax advisors now to model potential scenarios, understand their tax liabilities, and avoid surprises.

Employment Tax Changes

From **April 2025**, changes to employer **National Insurance contributions (NICs)** will mean higher tax costs for businesses, particularly those with larger workforces or higher salary bands.

What You Can Do:

- **Review Workforce Costs:** Assess your current staffing levels, salary structures, and future hiring plans.
- **Adapt Hiring Strategies:** Consider alternative approaches like part-time roles or outsourcing to manage costs while maintaining flexibility.
- **Forecast Impact:** Calculate how the changes will affect your bottom line and adjust budgets to ensure you're prepared.

Making Tax Digital (MTD) for Income Tax

The government's MTD initiative continues to expand. By **April 2026**, landlords and sole traders with turnover above £50,000 will need to comply, and by **2027**, this threshold will drop to £30,000.

What This Means for Businesses:

- **Real-Time Reporting:** You'll need to submit income and expenses digitally, requiring accurate, up-to-date record-keeping.
- **Tech Upgrades:** Investing in digital accounting systems now will avoid last-minute compliance issues later.
- **Support for Transition:** Training staff and working with advisors to adopt new systems will ensure a smooth transition.

Inheritance Tax (IHT) Changes on the Horizon

Major changes to IHT will come into effect from **April 2026**, including:

- A £1m limit on **business property relief (BPR)** and **agricultural property relief (APR)** for 100% tax relief, with 50% relief available above this threshold.
- Pension pots being brought into the charge to IHT from **April 2027**.

How to Prepare:

- **Start Succession Planning Early:** Discuss the implications of these changes with your advisors now to protect your family business or personal assets.

- **Review Estate Plans:** Ensure your current plans align with the new rules to minimise the tax burden on your estate.

Key Takeaways

The year ahead will be pivotal for businesses as they navigate higher taxes, new compliance requirements, and long-term planning challenges. Acting now can help you:

- Reduce tax liabilities by locking in current rates where possible.
- Adapt hiring and staffing strategies to control costs.
- Transition smoothly to digital tax systems under MTD.
- Plan for the future by aligning your estate and business plans with upcoming changes.

By staying informed and taking proactive steps, businesses can weather the changes and take advantage of opportunities in the shifting tax landscape.

Taxation on Tips and Troncs: Key Insights

With the introduction of the **Employment (Allocation of Tips) Act 2023** on 1 October 2024, new rules ensure that tips, gratuities, and service charges are fairly distributed to workers without unauthorised deductions by employers. However, the tax and National Insurance (NICs) treatment of tips depends on how they are allocated and paid.

Key Definitions

- **Tips:** Payments given by customers as a gratuity for service.
- **Tronc:** A pooling system for tips, managed by someone other than the employer (the troncmaster), who is responsible for distributing them.
- **Troncmaster:** The individual managing the tronc and responsible for setting up a separate **Tronc PAYE scheme** to distribute tips.

Tax and NICs Treatment of Tips

The tax and NICs rules differ based on who allocates and pays the tips:

1. When Tips Are Paid Directly by Customers

- **Tax**: Employees must report tips to HMRC via **self-assessment** or by updating their tax code.

- **NICs**: No National Insurance is due as the employer is not involved in the allocation or payment.

2. When Tips Are Paid by a Troncmaster Through a Tronc PAYE Scheme

- **Tax**: The tips are subject to PAYE (income tax) as part of the employee's earnings.
- **NICs**: **No NICs** (employer or employee) are due, as the employer did not allocate the tips.

3. When Tips Are Allocated and Paid by the Employer

- **Tax**: The tips are subject to PAYE and treated as part of the employee's taxable income.
- **NICs**: Both **employee and employer NICs** apply, as the employer is directly responsible for allocating and paying the tips.

Special Rules and Exemptions for NICs

Under **Paragraph 5 of the Social Security Contributions Regulations 2001 (SSCR), Sch 3**, tips are exempt from NICs if they meet one of the following conditions:

1. The tips are not paid, directly or indirectly, to the employee by the employer and do not represent monies previously paid to the employer (e.g., cash tips from customers).
2. The tips are not allocated, directly or indirectly, to the employee by the employer (e.g., tips managed and distributed by a troncmaster).

Summary Table: Tax and NICs Treatment of Tips

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Scenario	Tax Treatment	NICs Treatment
Cash tips paid directly by customer	Tax via self-assessment or tax code update	No NICs
Tips allocated and paid by troncmaster	Tax via Tronc PAYE scheme	No NICs
Tips allocated and paid by employer	Tax via employer PAYE scheme	Subject to employer and employee NICs

Practical Takeaways for Employers and Payroll Managers

1. **Understand Allocation Rules**: The **allocation** of tips determines NIC liability, while the **payment method** determines PAYE obligations.
2. **Use a Troncmaster for NIC Savings**: If tips are pooled and distributed by a troncmaster, both employers and employees can save on NICs.

3. **Comply with the Employment (Allocation of Tips) Act 2023**: Ensure tips are allocated fairly and in line with statutory requirements.
4. **Educate Employees**: Help employees understand their tax obligations for directly received tips.

By understanding these rules, employers can ensure compliance while minimising unnecessary costs.

Due Diligence on AI Suppliers: A Critical Step for Businesses

As artificial intelligence (AI) becomes increasingly embedded in business operations, it’s essential for firms to adopt rigorous due diligence measures when onboarding AI suppliers. This ensures compliance with legal and regulatory obligations, safeguards data and cybersecurity, and assures the integrity and functionality of AI systems. Below, we outline key areas businesses should address as part of their onboarding processes.

Traditional Assurance Measures

Most firms already have onboarding processes covering:

- **Supplier Business Operations**: Assurances about anti-money laundering, anti-bribery, anti-fraud measures, and financial stability.
- **Digital Solutions**: Assessments of the supplier’s skill, expertise, experience, and data handling practices, including privacy compliance measures like data-sharing agreements or cross-border transfer clauses.

While these remain important for AI systems, additional AI-specific measures are crucial.

AI-Specific Due Diligence

1. Data

Understanding the data used to train the AI solution is critical.

- What datasets were used? Are they open or proprietary?
- Were third-party consents obtained where necessary?
- Could intellectual property or bias issues arise from the data?

These checks are vital to avoid intellectual property infringements and uncover any potential biases in generative AI systems.

2. Testing

Comprehensive testing is essential for reliability and accuracy.

- Has the AI solution been tested, and if so, how and when?
- Are there commitments for ongoing testing?
- How will new releases be rolled out, tested, and managed if unforeseen issues arise?

Firms may also consider longer pilot periods to assess feasibility and performance before committing to long-term use.

3. Cybersecurity

AI solutions must include robust cybersecurity measures.

- What protections are built into the system?
- How will incidents be handled?
- For shared platforms, how will priorities be managed to restore normal operations?

Given the rise in sophisticated cyberattacks, firms must proactively address these risks, especially as insurers begin gearing up for a growing cybersecurity market.

4. Business Continuity and Disaster Recovery

Disaster recovery planning for AI must go beyond traditional events like fires or floods.

- What happens if the AI system malfunctions, such as rejecting a large volume of applications incorrectly?
- Should automated decision-making be paused, and what alternative systems can take over?
- Are governance structures in place to monitor automated decisions and escalate issues effectively?

Firms may require additional management information, frequent service provider meetings, and robust fallback mechanisms to ensure continuity.

5. Regulatory Compliance and Governance

AI solutions must comply with applicable legal and regulatory frameworks.

- Are the solution’s functions and performance mapped to legislative requirements?
- For cross-border operations, how will divergent regulatory regimes, like the EU’s AI Act versus the UK’s framework, be managed?

Governance processes should ensure ongoing monitoring, issue escalation, and accountability. Service levels must include remediation requirements to address performance failures effectively, beyond simple break/fix arrangements.

Managing Financial, Regulatory, and Reputational Risks

- **Financial Risk**: Suppliers should clearly outline their commitments, including compensation for regulatory sanctions or losses due to AI failures.
- **Reputational Risk**: Assurances should address how suppliers will collaborate with firms to manage and mitigate reputational damage.

Key Takeaways

With AI playing a growing role in automating and optimising business processes, the inherent risks and evolving regulatory landscape demand robust onboarding processes. Addressing these considerations early helps identify risks, ensures compliance, and establishes a foundation for long-term success. For businesses, thorough due diligence on AI suppliers is not just best practice—it’s a necessity.

Interesting Reads

- **Your Guide to Making Tax Digital Income Tax and Self-Assessment**

  You may have heard of the “buzz” around Making Tax Digital. From April 2026, it will change the way over 50,000 sole traders manage their taxes.
- **Revenue Recognition and Long Term Contracts in the Tech Industry**

  Did you know that 40% of tech companies struggle with proper revenue recognition for their long-term contracts, potentially leading to significant financial statement errors?
- **Taxes and Crowdfunding: Everything You Need to Know**

Most campaign creators concentrate on their pitch and marketing plan but generally forget the very important aspects.