Practical Tax Tips for the owner managed business

This briefing is intended for both unincorporated and incorporated business clients.

It focuses on some key direct tax areas affecting the owner managed business so that essential opportunities to maximise tax savings or minimise liabilities are not overlooked. Areas covered include capital allowances, extraction of profits and employment taxation. It includes the more important year end tax tips to help identify the areas that should be considered shortly before both the end of an accounts period and/or tax year.

Tax relief on plant and machinery

Significant tax relief is now available in respect of capital expenditure for businesses. This section summarises the key areas to consider to maximise relief.

The Annual Investment Allowance (AIA) of £50,000 is available on qualifying expenditure to all sizes of business whether they operate as a company, sole trader or partnership. However, a mixed partnership, being a partnership not made up solely of individuals, is excluded.

As the AIA provides for 100% tax relief on qualifying expenditure, it is essential to maximise its potential in reducing profits to minimise tax liabilities. It could even generate a trading loss for relief. It can be used on:

- plant and machinery
- commercial vehicles including motor bikes but excluding cars
- integral features which include lighting, air conditioning, electrical and heating systems.

Point to watch

The AIA may have to be shared between related businesses, meaning businesses which have similar activities or operate from the same premises in certain circumstances. This will apply where:

- an individual controls two or more companies or
- an individual has a controlling interest in more than one unincorporated business, for example as a sole trader and as a partner with a majority interest.

However, this rule does not apply where an individual has control of one company and one unincorporated business which could be a key decision in setting up a new venture.

Example

Carla currently owns 100% of Company A which operates as an Italian restaurant. Due to an inheritance she has recently received, she is planning on investing in a substantial kitchen refit. She is also planning to set up another company for a new pizza takeaway business. If she goes ahead with the creation of another company, her two companies will have to share the AIA. If alternatively she sets up the second venture as an unincorporated business both businesses will be entitled to an AIA of £50,000.

The allowance also has to be shared within a group of companies irrespective of the activities undertaken.

Energy saving plant and expenditure

In addition to the AIA, a 100% Enhanced Capital Allowance (ECA) continues to be available to every business for expenditure on energy saving plant and machinery which includes certain ‘green’ cars. Details of the types of plant and machinery products which qualify and the criteria which need to be met can be found on www.eca.gov.uk.

Temporary First Year Allowance

For plant intensive or larger businesses where the AIA is insufficient, time is running out to take advantage of the temporary 40% First Year Allowance (FYA) for expenditure on plant and machinery.

The additional capital allowance is only available for expenditure incurred on plant and machinery before 1 April for companies and 6 April 2010 for individuals and partnerships.

The temporary allowance takes the form of a FYA of 40% instead of the normal 20% annual allowance. The FYA does not apply to expenditure on integral features, cars, long life assets and assets for leasing. However it is available to all sizes and structures of business so take advantage before it disappears.

Small Pools

Businesses may also now be able to claim a one off allowance of up to £1,000 where the unrelieved balance to carry forward is £1,000 or less. This is to get rid of the tedious situation in smaller businesses where, for example, a main pool balance of £600 continues to be written off bit by bit each year by the annual allowance of 20%.

What about cars?

For expenditure incurred on or after 1 April 2009 (6 April for the self-employed) the allowances available are now based on CO_2 emissions rather than cost and there is effectively a distinction in this area between the tax treatment of cars purchased by companies and cars purchased by an unincorporated business.

For a company all car purchases are pooled either in the main rate or special rate pool as follows:

Cars not exceeding 110 g/km	Main pool - 100% ECA allowance
Cars not exceeding 160 g/km	Main pool - 20% allowance
Cars exceeding 160 g/km	Special rate pool - 10% allowance

On disposal any residue continues to attract the respective 20% or 10% allowance only. However, an unincorporated business has the advantage that where a car is used privately by the proprietor, the car is treated as a single asset. Such an asset attracts the same annual allowances whilst owned, but on disposal, an additional allowance would be available on any residue. This is known as a balancing allowance.

Tax Tip

From a capital allowances viewpoint it may be more advantageous to use an unincorporated business (for example a partnership) to purchase cars.

Reducing profits

It may be the case that a number of businesses are not currently making profits but the inclusion of this section is to highlight areas where cost acceleration can benefit from tax deductions which can either reduce tax payable or create losses for relief against other current income or for carry back.

Capital expenditure

The timing as well as the extent of the relief has always been an important consideration because of the effect on taxable business profits. Expenditure shortly before a period end can have an accelerated impact on reducing profits of the current period whereas spending early in the next period is not as beneficial from a cash flow perspective.

Provisions

Provisions properly made can reduce profits but must be in accordance with the relevant accounting standards (usually FRS12 for a company) so that a tax deduction is obtained. One area where provisions occur is bad debts. Evidence of actions taken to recover bad debts to support provision in this area is recommended.

Another area of particular attention is that of provisions for bonuses. To obtain a tax deduction it is not only necessary that they are paid within nine months of the accounting period end but also there must be a constructive obligation at the balance sheet date. This means that proper consideration of whether a bonus should be made is needed prior to an accounting period end with appropriate documentation.

Stock write off

Consider stock write downs as these are not only allowable for tax purposes but also prudent in the current climate.

Pension contributions

Pension contributions are tax efficient for both employers and employees/directors. From the individual's perspective employer contributions are tax and national insurance (NIC) free but those with incomes in excess of £130,000 in 2009/10 or in either of the previous two tax years should take advice if they are planning to contribute more than £20,000, due to targeted anti-forestalling rules which are not considered further here.

From the employer's perspective tax relief is normally available with no employer NIC cost, provided the overall remuneration package is justifiable.

Point to watch

Pension contributions must be paid in the period for a tax deduction to be obtained for the same period.

Using family members

Employing family members can be a very useful way of both spreading the tax burden within the family and obtaining a business tax deduction. Consideration should always be given to whether the overall package is reasonable and commercial for the value of the work undertaken.

Extracting profits wisely

Dividends v Bonus

Dividends continue to be more tax efficient than bonuses in most circumstances, due to the fact that the corporation tax deduction does not outweigh the added NIC costs of providing cash remuneration. This is particularly attractive for companies that pay corporation tax at 21%.

It is therefore essential that if a dividend extraction is required that attention is paid to company law procedures and that it is lawful. For dividends to be lawful they must meet two conditions:

- the company must have sufficient profits to finance the dividend and
- the dividends paid to shareholders must be paid according to the terms laid down in the Articles for that type of shareholding.

Loans

Making a loan for a temporary period to a director/shareholder does have a number of taxation implications but can be used effectively. For the company, where loans are still outstanding more than nine months after the accounting period end, the company will have to pay a 25% tax charge. However, this will eventually be refunded when the loan is repaid or written off. For the individual, they will be assessed on a benefit for the use of the funds at the official HMRC interest rate, currently 4.75% of the loans annually. The employer will be charged with Class 1A NIC on this element.

However, compared to awarding a bonus or declaring a dividend there may be a tax saving.

Avoiding the 50% tax rate

Key personal tax changes will affect those with higher incomes in excess of £100,000 for the new tax year 2010/11. The changes in outline mean:

- a gradual reduction in the personal allowance once income exceeds £100,000 such that an income level of £112,950 will mean a nil allowance.
- a 50% tax rate for taxable income in excess of £150,000 (42.5% for dividends).

A number of methods of reducing future tax by taking action now are in circulation and depend on the individual's precise position, so contact us if this is of interest to you.

For the self employed

Those running their businesses as sole traders and partnerships may want to think about changing their accounting date from, say, 30 April 2010 to 5 April 2010. This will mean that these profits will be taxed in 2009/10 and not 2010/11. A change may also allow overlap relief to be used to reduce the taxable amount. No commercial reason usually needs to be given to HMRC for such a change but a change to 5 April 2010 would accelerate the date on which the tax needs to be paid.

For owner managers and employees

One option is to accelerate the date of bonuses/dividends to pre 6 April 2010. Once again, this may avoid the increased rates of tax but will accelerate the date the tax has to be paid.

It may be felt that the company's cash flow cannot support large payments prior to 6 April 2010 but this may well not be the case. All or most of the money extracted can be lent back to the company by crediting the shareholder's loan account. Interest could then be paid on the loan if desired.

If any employees are holding share options that will create an income tax charge on exercise, they may wish to consider exercising them prior to 6 April 2010.

If you wish to discuss any of these matters please contact us.