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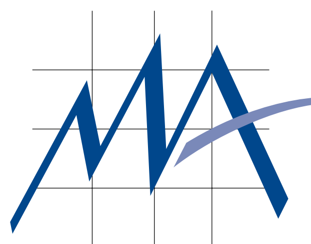

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Mabe Allen LLP is a Limited Liability Partnership registered in England and Wales.

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Tax tips and traps for the smaller company

This briefing focuses on selected practical tax matters for the smaller company so that essential opportunities to maximise tax savings or minimise liabilities are not overlooked.

Revenue or Capital

Ensuring that expenditure obtains full tax relief where possible is an essential objective. Revenue expenditure generally obtains 100% relief provided it is wholly and exclusively incurred for the trade or other business purpose.

> ***Tax trap***
>
> *Capital related expenditure connected to building alterations and improvements often results in no tax relief. Careful planning may be required to ensure that maximum savings are achieved, when projects which involve repairs, alterations or improvements to business premises are being considered. In particular, keeping different project elements separate and well documented is the key to success.*

The replacement of part of an asset (but not the whole) is classed as a repair for which 100% relief is allowed in the period in which it is incurred. An exception exists in respect of plant which falls to be classed as an 'integral feature'. This includes central heating, air conditioning, electrical, lighting and plumbing systems. The exception is that repair expenditure may be treated as capital not revenue expenditure in certain circumstances. This will be the case where within a 12 month rolling period, expenditure amounts to more than 50% of the equivalent of replacing the whole item in full. An example would be the overhaul of an air conditioning system where £45,000 is incurred but it would have cost £70,000 to replace the whole.

Capital allowances - where are we now?

Where capital expenditure is on qualifying plant and machinery, then the timing of that expenditure needs to be carefully considered to obtain the relief now that the maximum Annual Investment Allowance is only £25,000. Different routes are needed depending on whether annual capital expenditure is going to exceptionally or routinely exceed this amount.

> **Example**
>
> A company which makes accounts up to 31 March replaces a key piece of equipment approximately every two to three years. It last replaced the equipment in December 2010 when the AIA provided full tax relief coverage and estimates that it will need to replace the item before 31 March 2013 at a cost of £45,000.
>
> If the replacement asset is delivered in December 2012 and the bill is due and settled within say 3 months then the whole of the £45,000 falls into the year to 31 March 2013. This means that only £25,000 would be immediately relieved by the AIA. The balance of £20,000 would be eligible for the annual writing down allowance (WDA) of 18% providing further immediate relief of £3,600 but the excess of £16,400 would be carried forward for further relief in subsequent years, at a rate of 18% each period, on the reducing balance.

> ***Tax tip***
>
> *It is possible to structure acquisitions to delay the date expenditure is incurred for capital allowance purposes so that it is spread across two accounting periods to utilise the AIA and avoid wastage. One such method requires the acquisition to be made using a longer credit period. Any part of the payment which falls due in more than four months delays the trigger date for capital allowances. This rule does not, however, apply to hire purchase contracts which are subject to different rules so professional advice is recommended.*

> **Example**
>
> In the previous example, the contract to purchase the asset was negotiated such that in December 2012 £25,000 was payable on delivery and the balance of £20,000 was not payable until April 2013. In the annual accounting period ended 31 March 2013, AIA of £25,000 could be claimed on the amount due at delivery. Capital allowances on the balance are delayed until the next accounting period due to the long credit facility. However, this means that in the accounting period ended 31 March 2014, AIA of £20,000 can also be claimed.
>
> This results in 100% of the asset cost being relieved over only two accounting periods.

What if more than £25,000 is needed annually?

Where the nature of the business is more plant intensive then some other measures can be considered to increase capital allowances.

- Consider whether there is scope for the business to acquire energy saving or water efficient plant and machinery which includes certain 'green' cars as these qualify for 100% enhanced capital allowances without eating into the AIA. For further details of what qualifies go to http://etl.decc.gov.uk/etl or contact us for a review.

- Consider opportunities to make use of the 'short life asset' (SLA) rules to obtain full economic write off on disposal. This is detailed further below.

SLA - may save the day

This allows main pool plant items (not cars) to be isolated and treated as a 'single asset' for capital allowances. This can apply for up to eight years from the end of the accounting period of acquisition. Integral features are not eligible.

Initially such an asset is eligible for the same allowances (AIA and WDA) as would have applied if placed in the main plant pool. However, on disposal, where there is unrelieved expenditure after taking disposal proceeds into account, an extra allowance can be claimed for the unrelieved amount. This equates to writing off the whole of the cost (less disposal proceeds) of the asset over the actual economic life of that asset to the business.

Example

A commercial vehicle is to be purchased for £40,000 during the year to 31 March 2013. The company has already used its full AIA entitlement for the accounting period. This means that only 18% annual WDA is due and this will be calculated on the reducing balance of expenditure for each accounting period. After 6 full years the vehicle is scrapped but an unrelieved balance of £12,160 remains. If the asset has been separated from the main pool (a claim is required within a certain time limit) as a SLA, full relief on the balance can be obtained in the period of disposal. Otherwise, further amounts at a rate of 18% annually will continue to be received over subsequent years.

The immediate tax saving is worth £1,994 using the current 20% small company rate.

Profit extraction - what is best for 2012/13?

There are no changes to personal tax rates or National Insurance Contribution (NIC) rates for 2012/13 including the additional rate of tax of 50%. From a corporation tax (CT) perspective a small company continues to pay 20% but the main rate has now decreased from 26% to 24%. This reduces the tax saving effect of any forms of extraction which get CT relief like salaries, benefits and the related NIC cost.

This means that many owner/managers will continue to pay themselves a basic salary and extract additional funds through the use of dividends which do not get CT relief but which also do not attract NIC. For an individual whose taxable gross income does not exceed £42,475 overall in 2012/13, any gross dividend element (cash dividend received plus the non-refundable tax credit) does not attract any additional personal tax/liabilities.

The example which follows demonstrates the cost alternatives of providing a dividend or a bonus when a higher rate taxpayer wants to extract additional 'cash'.

Example

The cost of providing an after tax and NIC (where relevant) cash amount of £10,000 for an owner/manager from his family company is as follows:

The cost to the company of paying a dividend will be £13,333 irrespective of the CT rate. The individual only pays 25% effective tax on the net dividend = £3,333 tax.

The company will have to pay employer's NIC on a gross bonus (the individual then pays 40% tax and assumed 2% NIC). The net cost of the bonus will depend on the rate of CT paid by the company but will range from £14,715 to £15,696.

Benefits

Tax tip

CT relief is not available to a company on dividend payments so in some cases other extraction methods can be more advantageous. CT relief is due on tax free benefits which also do not attract NIC cost. These should be considered for all sizes of company and include employer provided childcare vouchers, a mobile (or smart) phone and employer pension contributions to a registered scheme. In addition, rental income or interest extraction can be tax efficient so please contact us for further guidance on this area.

Whilst the small company can use tax efficient benefits effectively, it is also more vulnerable to certain pitfalls.

The provision of a 'smart' phone is only tax free where that provision is made by the employer. For the owner/manager this means that it is the company which must have entered into the contract not the individual personally. Where the contract is between the individual and the supplier but the bill is settled by the employer, this is neither tax nor NIC free. Rather, in this particular situation the individual as well as the employer would be liable to NIC.

Finance by loan or equity?

A perceived advantage of the owner/manager providing loan finance, rather than equity finance, is the ease with which loan finance, can be repaid to the individual once there are sufficient funds available in the company. This was not generally possible with share capital unless the company went into liquidation. However, changes to the Companies Act rules in relation to the return of share capital have altered in recent years.

The rules now allow a company to return share capital which is in excess of its needs. The provisions require a special resolution supported by a solvency statement made by the directors.

Why it matters?

A loss on a loan can only give rise to a capital loss whereas a loss on ordinary shares may give rise to either a capital loss or income tax relief. In both cases, certain conditions have to be satisfied.

For a loan to be recognised as an allowable capital loss the company must have used the funds for the purpose of its trade and the loan must have 'become irrecoverable' (so if the company is already in financial difficulties at the time the loan is made, HMRC may reject the claim). Where a capital loss is available this may be set off against capital gains realised by the individual or carried forward until such time as gains are realised in the future.

A loss on shares will be a capital loss under the general provisions of capital gains tax (CGT). A loss on shares subscribed for in a qualifying trading company may then be relieved against income rather than capital. Certain trades are excluded. 'Excluded activities' include leasing, providing legal or accountancy services, property development, farming, operating or managing of nursing homes and those dealing in shares, securities or land. We can advise on this in further detail but companies which qualify under the Enterprise Investment Scheme or the new SEED Enterprise Investment Scheme automatically qualify.

Tax tip

This facility to convert a capital loss on qualifying shares for use against income can save tax at the higher and additional rates currently 40% and 50% respectively and is currently unlimited. Proposals for 2013/14 include reducing the top rate of tax from 50% to 45% and capping the amount of reliefs that can reduce income. So, 2012/13 is a good time to review whether any of your past investments qualify.

Even where there is no actual disposal of the shares, a claim can be made if the value of the shares has 'become negligible'. Relief may be denied if the company was already in financial difficulty at the time of the share issue.

Profit extraction - capital

The main concern for many owner/managed businesses will be to secure the availability of Entrepreneurs' Relief (ER) to obtain a 10% CGT rate on an eventual disposal of trading company shares. This will not be the desired outcome to the extent that a taxpayer has basic rate band capacity, as dividend extraction has no additional tax cost. Once that is used capital extraction will be preferred. Any shareholder wishing to benefit from ER has to hold at least 5% of ordinary voting shares and be an employee or officer of the company throughout the 12 months prior to a disposal. Two topical areas to watch are as follows:

- Where the company evolves from a pure trading company into other areas of activity then the level of that other activity needs to be monitored to ensure that it does not reach a material level, otherwise, ER may not be available.
- Companies with distributable reserves of more than £25,000 cannot obtain a capital extraction to secure ER by informally closing down. They must be formally liquidated.

For further advice or information on any of the areas covered or a more comprehensive review of tax matters affecting you and your company please contact us.

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