

ALAN PINK TAX

Year End Profit Reduction

Not all businesses make up their accounts to 31 December each year, of course, but it is one of the most popular accounting year ends, second only to 31 March, and so it seems topical to discuss, in an article written in December, the various techniques there are for reducing the profit on which your business pays tax.

So in what follows I've singled out what are probably the seven most popular ways of slashing your business tax bill, some of which demand action prior to your year end date.

1. **Accounting Provisions**

Most people who aren't accountants and know nothing about finance think that the question of how much profit your business has made is a simple one. You take the income, right? Then you take the expenses off that, OK? And the result's the profit. What could be simpler?

It isn't just accountant's love of mystifying the general public which leads me to say that, "no, actually, it's nothing like as simple as that." Your profit depends on the valuation at the year end of all kinds of things, depending on the business, and the answer is sometimes by no means obvious.

If your business provides credit to its customers, for example, how do you know you are going to get the money in? It's important to look very carefully down your list of debtors at the balance sheet date to see whether any of them seem doubtful, or just downright bad. In these parlous economic times, you're probably justified in taking a much more pessimistic view than usual. Remember, here, that the Revenue are very hot on the date the accounts were signed off. It's no good putting in a bad debt provision, which reduces your profits, if, by the time you actually come to approve the accounts finally, this debtor has awkwardly paid you! Delaying finalising your accounts can actually work against you, in practice, if your bad debt provision is thereby proved to have been too pessimistic.

Another valuation issue which affects your year end profit is that of stock and work in progress. If your business holds stock, take a very critical look at every item to see whether you think you will be able to sell it, and if so, whether you will get less than cost for it. Accounting rules say that you have to write down stock to its net realisable value, and the Revenue insists that this be done on an item by item (or at least line by line) basis. **Don't** make the mistake of putting in a general provision for stock obsolescence or the like. The Revenue will put a line through this. When you do the stock take you have got to be a lot more careful and detailed than that, but remember that every £100 you write your stock value down by is a corresponding amount off your year end tax bill.

The question of stock valuation is particularly relevant at the moment in the case of property dealers or developers. Remember that this stock test is one sided – in your favour. If you have properties which are worth less than they cost you, you are entitled to write them down, and by doing so, reduce the business' profit, perhaps even turn it into a substantial loss which you can carry across or back against other income, and get a tax refund. The converse doesn't apply: you don't need to write up properties which are worth more than they cost.

The other area where valuation can have a big impact on your profits is where you might need to make refunds, or do remedial work, for customers.

There are hundreds of examples of this sort of situation. IFA's, for example, who sell investment products, are sometimes on a deal that they have to pay back the commission if the client rejects the investment too early. Make an accurate assessment of the likelihood of this, and you can put in a provision against such possible future refunds which is an allowable tax deduction. Businesses selling goods on warranty should make an accurate calculation of how much they are likely to need to do to fulfil that warranty. And there are many other examples.

Accountants don't just allow you to take a pessimistic view of things like this in your year end accounts, they positively encourage it.

Just one more point before I move on. I've used the word "accurate" a couple of times when talking about provisions, and there's a very good

reason for this. The Revenue have a very important case on their side which says that a provision for future expenditure, like putting right work or goods under warranty, is allowable, but only if the provision has been calculated scientifically enough. This is a strange decision no doubt, of the sort that judges seem to like coming up with, but the fact of the matter is, if your provision is calculated accurately enough, you can have it, but if its too vague and general, you can't have any deduction at all. Logic? We're talking about the law here!

2. **Pension Contributions**

These used to be one of the few completely black and white allowable tax deductible items: you made a contribution into a Revenue approved pension scheme and that was an allowable deduction for the company.

Obviously this wasn't to the Revenue's liking, containing as it did no grey areas, that is areas of judgment, and no complexity. Taxpayers actually knew where they were. So, of course, that had to change, which it duly did in 2006 with the introduction of a new rule that pension contributions have to be "wholly and exclusively for the purposes of the business".

What this means in practice is that it has to be of a reasonable amount given the services of the employee concerned to the company.

In fact, the same rule applies now as used to apply to contributions to unapproved pension schemes.

With one possible exception, the rules for unapproved pension schemes have also changed, so that no deduction is now allowed for such contributions at all, or at least not until such time as the pension scheme has paid out to its beneficiary on retirement.

3. **Capital Expenditure**

This is definitely one where you need to act before your year end. Small businesses (into which category most readers of this column are likely to fall) are eligible for the so called "annual investment allowance", which is basically a complete, 100% write off of all of their capital expenditure on plant etc, in the year in which the expenditure on that plant was incurred. The "cap" on the amount allowable is £50,000, but on top of the AIA Gordon Brown has very kindly introduced a first

year allowance again, in the most recent Budget. This gives you a further accelerated write off of your capital expenditure.

So, if you were thinking about upgrading your computers, refurbishing your fixtures, or even just laying new carpet, bring it forward to just before your year end and you will have 100% tax write off – a year earlier.

4. Fixtures and Fittings

I know I bang on about this one, but I do seem to be rather a voice crying in the wilderness, to judge from all the cases which come across my desk month by month.

What this is all about is fixtures which are inherent in the fabric of a property. If you buy a commercial property, you're buying, usually, a lot more than just the bricks and mortar or equivalent. You are buying heating, power, air conditioning systems, fitted furniture, roller shutter doors, all kinds of things, in short, that are actually allowable against tax.

The reason I feel like a voice crying in the wilderness, on this point, is that, in the vast majority of cases, this bit of tax deductible "treasure" is overlooked.

So, if you are looking at ways to cut down your year end tax, why not look at your balance sheet and see whether there is anything there under the heading "freehold property" or "leasehold property", under the fixed asset heading, which might have been unthinkingly allocated to this category and therefore missed out on the capital allowances that are justly due.

Depending on the type of building, you could find anywhere between 10% and 50% of that cost is actually claimable – even if you actually bought the property concerned many years ago.

5. Provisions for Salaries and Bonuses

Some people don't realise that you can claim relief for remuneration paid to directors, or bonuses paid to staff, before you've actually paid them.

Providing the obligation to pay the remuneration or bonus concerned is a binding one at your balance sheet date, you can put in a provision equal to the amount you are going to have to pay, plus employer's national insurance, and claim this as a deduction against this year's profits.

With directors, you can actually get a significant benefit, not just in timing terms but even in the amount of tax involved, by doing things the right way. Let's take an example.

Two directors run a company, which makes up its accounts to 31 December. They hold a formal board meeting, at which it is minuted that £100,000 will be payable to the directors as remuneration following the finalisation of the company accounts.

Because this is a formal decision, it becomes a liability of the company which means that the accountants are obliged to put in a provision for £112,800 (that is, including employer's NI) in the year end accounts. The corporation tax is correspondingly reduced.

However, the remuneration isn't actually paid over until after the following 5 April, when it falls into a new tax year. Hence, our example goes on, the directors concerned have a new set of basic rate allowances and personal allowances to offset, which minimises their personal tax. Without planning, this remuneration might have just been paid to them as part of their ordinary salary, and wouldn't have secured a tax deduction in this year.

Be careful, though, with directors' remuneration. If you do things wrong, you can end up effectively triggering "payment" of the remuneration just by being too definite about who is due to receive it. The answer is to put in a general provision for remuneration which is non specific between individuals.

In the case of staff who aren't directors, the principle is exactly the same, that you have to make the obligation to pay bonuses a legally binding one for it to be entered into this year's accounts as a provision.

With both directors and other employees, there's now an overriding rule that the remuneration etc has to be paid within nine months of the year end. In the "good old days" (from the tax planner's point of view) there was no such requirement and a number of people had the intelligent idea of putting in provisions for remuneration but never

paying it, or not paying it for many years. In this way the company got a tax deduction years before the directors had to pay their PAYE and NI. It was too good to last!

6. **Trading Losses**

Sometimes there may be allowable trading losses floating around, somewhere, that the company or other business entity hasn't even fully realised the existence of.

An example is where your business might have entered into some kind of joint venture agreement or partnership with another person, perhaps to develop a bit of land, or to carry out any other kind of trading activity.

Especially in the current climate, it may be, further, that this joint venture would show a book loss if you were to make up accounts to a date round about the current time. By bringing the accounts forward, and by formalising your role in this joint venture, you can sometimes bring about relief for a loss (even if only temporary) of your investment in this other enterprise, and relieve this against your profits this year.

So it might be worth ransacking your balance sheet, again, to see whether there are any amounts in "debtors" or under the "investments" heading which actually represent involvement in a loss making trade of any kind.

7. **"Aggressive" Schemes**

I've left the juiciest, but also the most controversial, method of profit reduction until last.

There's a whole industry out there, employing a lot of exceedingly clever people, whose aim is to arrive at loopholes in the law. And what they come up with is often very inventive and even pleasing, on an intellectual level, indeed.

One of the front runners in the list of aggressive schemes is the Employee Benefit Trust arrangement. In its earliest and simplest form this involved the company making a payment to an Employee Benefit Trust which normally was for the benefit of all its employees, subject to the trustees' discretion. A deduction was claimed for the contribution.

The money actually within the trust was then lent back to the main director of the company. Note the devilish cunning, here, though. A normal loan such as this would give rise to a benefit in kind on the director on which he would have to pay tax and the company would have to pay employer's national insurance. But they thought of that, and made the loan interest bearing at a commercial rate. They just refrain from collecting the interest, rolling it up as an addition to the loan. So, the idea was, they company would get an entirely one sided deduction for the contribution to the EBT, which wasn't mirrored by a tax charge on the director.

The reason I've been using the past tense in all of the above is because the Revenue have legislated against EBT's more than once, and made blood curdling threats against those who use this sort of planning. As recently as October of this year, they have described EBT's as one of their principal tax avoidance targets.

So, although EBT's are still being marketed you need to be aware that you are sticking your head above the parapet.

Generally speaking, a feature of these aggressive schemes is that they aim to eliminate tax on profits without any "real" commercial loss being incurred by the business. Generally speaking (although I suspect the promoters, who are bright cookies, have even thought of a way round this) they are disclosable to the Revenue under the "Disclosure of Tax Avoidance Schemes" rules, a particularly "below the belt" form of legislation that we borrowed from America a few years ago. Where you put forward an aggressive scheme of this type, you are meant to notify the Revenue within the incredibly short time scale of five days. They then use this information to shut down the loophole.

Aggressive tax planning comes in for a great deal of moral censure, particularly, of course, from the Revenue themselves, and from politicians. My personal view is that this moral censure is entirely misplaced: it implies that our tax system would produce a "fair" result but for this aggressive avoidance activity, but to anybody who knows anything about our tax system this assumption is too laughable even to discuss. But what is against the schemes is not the morality question, in my view, but the degree of risk involved. You have to be somebody who doesn't mind putting their head above the parapet, and perhaps having to argue your case for many years, with no certainty that, at the end of the day, some judge isn't going to "interpret" the rules in such a

way as to defeat the planning. Having said all this, though, there are arrangements out there, which are less in the spotlight than EBT's, which for those of you who are not particularly risk adverse might be interested in having a crack at. I don't promote these schemes myself, but I know a man who does...

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