How to run your business by the books

The common opinion of the population is that the tax inspector is a person to be despised. In reality, the individuals who work for Her Majesty's Revenue and Customs are, on the whole, normal, decent people. As in all walks of life, there are the odd extremes. The art of dealing with them is to stick to the facts. Tax law was written so the government could finance public spending. Since the recession of 2008, the UK government and many others around the world have found their finances under pressure. As a result, the government has become much more demanding and looks to retain cash wherever possible. In my experience, tax repayments have been taking longer and longer and involve much more red tape than was the case before 2008. As much as possible, avoid the need to rely on repayments from HMRC.

The best way to manage your taxes and other compliance issues is to obtain qualified expert advice. Do it upfront – don't wait until you have a problem!

Dangers of Unqualified Advice

There are numerous horror stories about taxes, as many businesses have come to Pentins for advice after having taken the cheap option: of consulting unqualified tax advisers.

One was told they didn't need to complete a tax return as they hadn't been sent one! Another was in such a mess the tax inspector opened a huge personal enquiry that went back six years.

Types of taxes

Business tax

Businesses are taxed on profits made during the period in which they operate – usually annually. A business could be charged income tax, partnership tax or corporation tax, depending on its structure, and the percentages can range from 19% to 45%. In general, the more profitable a company is, the more business tax it will incur.

Employment tax

The government also charges tax based on the wage roll of the business. Currently this is 13.8% of amounts paid to employees. The government uses the term 'employer's national insurance' rather than 'tax' in this case. In addition, there are further taxes on the employees themselves; in the UK this is known as pay as you earn (PAYE) tax. The business is used as an unpaid tax collector for the government. PAYE can be as high as 45%.

Consumption tax

In the UK, consumption tax is known as VAT. In other countries, it's commonly referred to as general sales tax (GST). VAT is added to the initial sales value and charged to your customers. You are required to charge VAT if your turnover exceeds £85,000 (2018).

Capital tax

In the UK, this is known as capital gains tax, and it's a tax on the increasing value of the business or its assets, such as property or investments. Depending on the type of business, this tax can range from 10% to 28% in the UK.

Avoid the tax pitfalls

As your business grows, you'll pay more tax. For every pound you spend in a profitable business, assuming the business makes a profit of 20%, the total tax could be as high as seventy-five pence in the pound. It's impossible to avoid paying tax to the government, but what you can do is manage your affairs so as to pay only the minimum amount of tax you're legally required to pay. How do you do that?

You need to seek out as much tax relief as possible. For example, almost every business owner has a mobile phone, but how many are claiming tax relief on the phone, which is specifically exempted from employment tax? Or claiming part of their home expenses if they work from home? More reasons for choosing the right qualified accountant.

EIS

The government has introduced schemes such as the EIS, which provides tax relief to investors who invest in small businesses. If you set up a business using the correct structure, you can ensure that you pay only 10% capital gains tax rather than 20% by fulfilling the requirements for entrepreneur's relief. As companies grow, they can slip back from 10% to 20% by failing to qualify for entrepreneur's relief. If the business is worth £5 million, for example, the extra tax would be £500,000. So, make sure you review your capital gains tax situation at least annually.

Protect future reliefs

An entrepreneur had built up significant reserves (almost £5 million) in his successful limited company. As he had a limited company, his financial information was disclosed at Companies House online, in the public domain. He started to receive feedback; his customers said his prices were too high, and his suppliers thought he should pay them more.

Because of the way taxation reliefs work, this also meant that the company could be classified as an investment company rather than a trading company, leading to higher taxation. Generally, capital gains tax is higher for an investment company than for a trading company.

By restructuring the business and splitting the trade and investment assets into two separate businesses, we were able to save our client over £200,000 in capital gains tax. He moved his trading business to a completely different company with much lower reserves and the £5 million ended up in a separate investment company and was no longer in plain sight of his customers or suppliers. The overall result for the client was a lower tax rate and a better commercial negotiating position.

Tax Enquiries

Because of the government's need for cash, it has developed a targeted tax-enquiry regime. It's fairly simple: before getting a refund, you're likely to receive a visit or an enquiry letter from a tax inspector. Often these visits result in a delay of repayment, but if the company is badly managed, they can lead to penalties and extra tax. In my experience, a business which keeps good records and has a thorough trail of transactions will have nothing to fear from a visit from the tax inspector.

Top reasons for being selected for an enquiry

1. You have asked for a tax repayment
2. There has been a significant change in your trading profile (eg, sales have halved or doubled) with no obvious explanation
3. Your trading performance is different from those of similar businesses in your industrial classification
4. You have had an enquiry before and the outcome was such that the tax authorities perceive there is a risk of tax not being fully disclosed or paid (a polite way of saying you're on the heavy scrutiny list)
5. You are subject to a random check
6. You are a 'high net worth' individual and invited to join HMRC's High Net Worth Unit

In recent years, the government has used psychologists to draft letters and word them in such a way as to nudge you to pay (and ultimately increase the overall tax take). Again, you need a qualified tax adviser that you can call on if you're an entrepreneur in business. Remember, the government is just like any other business – it needs cash, and its main source is the taxpayer.

What happens during a tax enquiry?

Generally, step one involves ascertaining the facts and what actually happened during any transaction. Next, the applicable tax law is applied to the transaction and the tax is calculated. At this point there could be an element of subjectivity; negotiation may be required.

Finally, the tax authorities will make a decision. It then becomes a matter of whether you acted reasonably and disclosed all the facts. HMRC will either issue a penalty or an interest charge or will simply agree with how you have followed the tax rules to assess your tax. You will have the option to appeal or negotiate time to pay.

The key is to prepare the information for the tax authorities correctly, using the applicable tax law and maximising existing reliefs and allowances.

I haven't yet met a client who wants to pay more tax than is legally required. I also have many clients who just want peace of mind – to know that if there is a problem, they have someone to take it on for them.

Staying ahead of the legislation

Once you reach the turnover threshold of £85,000 per annum, you must register for VAT. At this point, you will have to charge an extra 20% VAT on top of your sales price (there are certain exceptions for some businesses). You also benefit by being able to reclaim the VAT that is charged to you.

The best way to manage VAT is to use a cloud accounting system that can track it for you. Most cloud systems will prepare the VAT return for you and allow you to submit it from the software. Automate as much of the transaction recording process as possible, and ensure you use the most applicable VAT schemes.

Once VAT is under control, if you employ people, you will need to set up and operate a PAYE account for salaries and wages on a monthly basis. Again, automation is key here, and strong PAYE software systems will keep the process smooth and simple.

Having paid your VAT and your staff (which includes you if you're a director) throughout the year, at the end of the year it's time to calculate the business profits and the resultant tax on those profits. Although this could be a DIY task, I would advise against this. Things could go horribly wrong. Business profits are calculated using International Financial Reporting Standards, which govern how to treat the financial transactions a business has made.

Let me give you an example of how confusing some Financial Reporting Standards have become.

What is the value of an interest-free loan of £100,000 taken out by a business and repayable five years from now (ie, the business will pay back £100,000 in five years' time)?

a) £100,000
b) £82,193
c) £116,985

Until recently, the answer was a). Now, the correct answer is b)! This is based on the present spending value of money. Assuming the cost of money on the bank loan markets is 4% each year, the value of £100,000 received in five years in today's terms is £82,193. (This represents the amount of money you would need to invest now that, with 4% per annum growth, would amount to £100,000 in five years' time.) What happens to the difference of £17,807? That goes to the business profit-and-loss account, which is taxable in that year.

Once the annual accounts are produced, you can then calculate the tax due on the profits, and also know how much is available to pay out as dividends.

Wouldn't it be better if you knew how much tax you were going to have to pay and how much you could legally draw down as you went along? That's all possible if your system is set up to automatically produce those figures for you.

Statutory matters

To balance out the protection of limited liability sta- tus, LLPs and limited companies are both required to submit accounts in a specified form to Companies House. There are a myriad of exemptions and requirements based on the size of the business. The standard submission time limit for both an LLP and a limited company is nine months after the period end (or in the case of a new start-up, twenty-one months after incorporation).

The statutory accounts have been developed with legislation in mind and are used for the following:

1. To calculate the taxable profits and subsequently the tax
2. To calculate the distributable reserves
3. To provide a basis for credit-rating agencies to apply a credit score

The accounts are *not* the most appropriate tool to manage your business on a day-to-day basis, nor are they the most appropriate method for valuing your business.

The corporation tax return is completed using the statutory accounts as the basis, but the profits can then be amended in line with specific taxable and non-taxable adjustments (eg, entertaining and depreciation of assets).

The tax for companies with annual profits of less than £1.5 million is due nine months and one day after the period ends. If the period is longer than twelve months, two returns will be required.

Companies House also requires a confirmation statement every year. To complete one, simply check the business information you registered at Companies House and confirm that it's accurate and up to date.

You are required to submit the accounts and the confirmation statement annually. In addition, you also need to prepare periodic payroll returns (quarterly, monthly, or weekly), VAT returns, and benefit-in-kind returns (P11Ds). You must also keep records of dividends paid.

Many entrepreneurs trip up over the above, or account for things incorrectly. The most common issue is not understanding the difference between a director's private funds and company funds.

Often, understandably, entrepreneurs just want to obtain results and will either use private funds (eg, personal credit cards) rather than business funds, or do the opposite and spend company funds (because they're there) on private items. If this happens, a director's loan account will be created, either an asset if funds are due to the company or a liability if they are due to the director.

To overcome this, keep an up-to-date statement of your director's loan account. Cloud accounting systems will help you create a report that will enable you to keep a running balance and also predict any problems that could arise in the future.

The most common problem arises if a director owes the company more than £10,000 and doesn't repay it within nine months. The company will then be required to pay a loan tax charge of 32.5% of the outstanding balance. If the director repays the loan within four years, the company can reclaim the loan tax charge against future corporation tax. Keeping a track of the loan account balance is therefore critical to controlling this tax.

Next Steps:

Entrepreneurs should be spending their time working on their ideas and plans rather than on detailed compliance work. With this in mind, hire an accountant who knows exactly how to help you succeed and see it as an investment rather than a cost. Remember, a great accountant can save you a lot more than what you pay them in the long run!

Looking for ways to save your more of your hard earned money from the taxman? Read our **Top 10 Tax Tips** and stay ahead of the game!

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