2021/22

YEAR-END TAX PLANNING FOR BUSINESSES

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BUSINESS

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- IR35 – Tax Tips for Contractors;
- How To Maximise Deductions For Business Expenses;
- Tax-Efficient Business Exit Strategies;
- Cash Basis for Landlords; and
- Director's Loan Accounts Explained.

1 About this guide

As the end of the tax year or the accounting period approaches, it is a good time for businesses to take stock and review their affairs. No-one likes to pay tax unnecessarily, and a little time spent considering the tax position ahead of the year-end can realise considerable tax savings. Now is the time to ask questions such as:

- Have we claimed a deduction for all available expenses?
- Have we claimed all the tax reliefs to which we are entitled?
- Have we made best use of all the available tax allowances?
- Do we have losses and how best should we utilise them?
- Should we consider changing our accounting date?
- Should we bring family members into the business?
- Have we made sufficient pension contributions?
- Have we claimed capital allowances?
- When is the best time to realise gains?
- Should we pay a dividend?
- Should we pay a salary?

While some of these questions are relevant regardless of whether the business operates as a sole trader or other unincorporated business, as a partnership, or as a company, other questions (such as the issue of whether to pay a dividend) are only relevant to a particular business structure (in this instance, a company).

This guide considers the answers to these and other questions in the content of year-end tax planning for businesses. For ease of use, there are tips of relevance to sole traders and unincorporated businesses (see Section 2), partnerships (see Section 3), and family and personal companies (see Section 4).

As well as the more general year-end considerations, there are also considerations of particular relevance to 2020 and the 2020/21 tax year, which apply as a result of the Covid-19 pandemic. These are examined in Section 6.

2 Sole traders and unincorporated business

2.1 Overview

A sole trader is the simplest set-up type of business set-up. The proprietor gets to keep all of the profits; however, he or she is also liable for all of the business debts.

From a tax perspective, a sole trader is taxed on his or her total income after deducting his personal allowances – the profits of the business are not taxed separately but form part of the sole trader's taxable income, together with income from other sources, such as any employment or investment income.

Consequently, when looking to minimise his or her overall tax liability, a sole trader cannot consider the business in isolation – it is also necessary to consider what other income and gains are received in the year, as this will impact on the individual's tax position and therefore on any tax planning that is undertaken. For example, if the sole trader has already used his or her capital gains exempt amount realising personal gains in the tax year, it may be advisable to delay realising a business gain until the start of the following tax year.

The following tips, therefore, not only cover the business but also the individual's overall tax position, as for effective year-end tax planning, the two cannot be considered in isolation.

For 2020/21 the impact of the Covid-19 pandemic also needs to be taken into account. Where the trader has received grants under the Self-Employment Income Support Scheme or from the local authority, these need to be taken into account. Sole traders struggling to pay their tax bills can look to take advantage of the Covid-support measures allowing tax to be paid in instalments. These are discussed in more detail in Section 6.

2.2 Basis of accounts preparation – Cash basis v accruals basis

One of the decisions that needs to be made is the basis on which the accounts are to be prepared. Sole traders and unincorporated businesses whose turnover (computed on a cash basis) is £150,000 or less can choose whether to prepare accounts using the cash basis or whether to use traditional accounting and prepare accounts using the accruals basis.

Practical tip

Decide which basis of accounts preparation best suits your business.

2.2.1 The cash basis

The cash basis is the simpler option. Under the cash basis, the trader need only take account of money in and money out. Income is only recognised when the cash is received. An advantage of this is that it provides automatic relief for bad debts. On the flip side, relief for expenses is only given when the bill is paid. Simplified rules also apply in relation to capital expenditure where the cash basis is used. Unless the expenditure is of a type (such as cars and land) for which a deduction is expressly disallowed, capital expenditure is simply deducted in working out the profits of the business; there is no need to worry about capital allowances (except in relation to cars).

The cash basis will not suit every business. For example, it may not suit your business if you want to claim relief for interest or bank charges of more than £500, as under the cash basis, the deduction for these items is capped at £500. Likewise, the cash basis may not be suitable if you have losses and substantial non-business income and wish to claim sideways loss relief. You may also prefer to stick with traditional accruals accounting if your business is more complex, for example, if you have high and varying levels of stock.

If you decide that the cash basis is for you, you need to elect for it to apply (by checking the requisite box on your tax return). If you are entering the cash basis for the first time, transitional rules apply to ensure that income is neither double counted or slips through the net as you move from the accruals basis to the cash basis, and similarly, that relief for expenses is not given twice or not at all. Once a trader is within the cash basis, they can remain in it as long as their turnover does not exceed £300,000. For universal credit claimants, the cash basis entry is doubled. If the exit limit is reached, the sole trader will need to move back to traditional accounting.

2.2.2 Traditional accounting: The accruals basis

Sole traders and unincorporated business that are not eligible, or do not elect to use, the cash basis must prepare their accounts instead using the traditional accruals basis. Under the accruals basis, income and expenditure are matched to the period in which it was earned or incurred rather than being taken into account when the income is received or the expenditure paid. This means that it is necessary to take account of debtors and creditors and work out prepayments and accruals. A deduction for capital expenditure is not permitted under the accruals basis; instead, relief for capital expenditure is given in the form of a capital allowance.

The accruals basis is the default basis for traders in the absence of a cash basis election.

2.3 Consider changing your accounting date

The accounting date – the date to which accounts are prepared – will in the early years of a business determine how much of the profits, if any, are taxed twice, and also the amount of time between the end of the accounting period and the date on which tax is payable.

Once the business is established, the profits that are taxed for a tax year are those of the accounting period ending in that tax year. This is known as the current year basis.

If a trader prepares accounts to 31 March, the profits for the year to 31 March 2021 will be taxed in the 2020/21 tax year. However, if the accounts are prepared to 30 April each year, it will be the profits for the year to 30 April 2020 which are taxed in 2020/21. The earlier the accounting date falls in the tax year, the longer the trader has to pay the tax on those profits. Tax is payable by 31 January after the end of the tax year, with payments on account of 50% of the previous year's tax and Class 4 National Insurance liability being made on 31 January in the tax year and 31 July after the tax year, where the previous year's liability is £1,000 or more.

In the early years of a business, if the accounting date is other than 31 March – 5 April, some profits will be taxed twice. Relief for these profits (overlap profits) is given either when the business ceases or where the accounting date is changed.

2.3.1 Changing the accounting date to benefit from overlap relief

Special rules apply to determine the profits in the first three years of the business. These may result in some profits being taxed twice. The profits that are taxed twice are known as 'overlap profits'.

From year four onwards, a self-employed trader can change his or her accounting date. The first accounts to the new date cannot be for a period of more than 18 months. HMRC must be notified of the new date in the self-assessment tax return for the year of the change. If the accounting date has been changed in the previous five years, the change must be made for commercial reasons. It should be noted that HMRC does not accept the obtaining of a tax advantage as a commercial reason.

If the change of accounting date results in a shorter accounting period, this will result in overlap profits, which will be relieved at a later date. However, where the change of accounting date results in a long accounting period, relief may be available for earlier overlap profits.

Example: Change of accounting date: Short account

Joe is a sole trader who has prepared his accounts to 31 December for many years. To improve his cash flow, he wishes to move to an accounting date of 30 April. He prepares accounts to 31 December 2020 (the profits of which are taxed in 2020/21) and for the four months to 30 April 2021.

For 2021/22, he is taxed on the profits for the 12 months to 30 April 2021. As a result of the change of accounting date, the profits for the period 1 May 2020 to 31 December 2020 are taxed in both 2019/20 and 2020/21. The profits for the overlap period will qualify for relief in a later year.

Example: Change of accounting date: Long account

Poppy started her business many years ago on 1 July 2004 and has always prepared accounts to 30 June. She wishes to change her accounting date to 31 December. She prepares accounts for the year to 30 June 2020 (the profits for which are taxed in 2020/21) and for the 18 months to 31 December 2021 (the profits of which are taxed in 2021/22).

In the early years, she was taxed on the profits from 1 July 2004 to 5 April 2005 twice. The overlap period is nine months.

On the change of accounting date, as her accounting period exceeds 12 months by six months, she can claim relief for six months' worth of the overlap profits from the earlier years.