

Getting the tax man to pay for your business.

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Today's agenda.

- Some basic finance ideas.
- Accounting profit and taxable profit.
- Depreciation and capital allowances.
- Capital expenditure and capital allowances.
- R&D and the tax system.
- Patent box.
- Any questions?

Basic (or advanced) ideas in finance.

- Finance is all about net cash flow (£s coming in less £s going out).
- We prefer more cash now to less cash now.
- We prefer a given amount of cash sooner rather than later (e.g. because we can put cash to work to earn a return).
- **Key Implication: We prefer a lower tax bill paid later rather than sooner.**

A warning.

- Finance is about maximising the present value of after tax cash flows.
- Take advantage of legal means of reducing taxes consistent with your business plan.
- But don't form your business plan around the pursuit of tax advantages.

What about profit?

- If it is a finance question the answer involves cash flow not profit, with one exception....
- Tax is calculated on the basis of profit not cash flow.
Tax Due = (Revenue – Costs) x TaxRate.
- We all have a “reasonable sense” of what constitutes revenue and costs, but sometimes we get it wrong.
- In fact taxable profit and accounting profit usually aren't the same thing.

Profit (and loss)

- Here is a simple Income Statement (P&L)

Revenue	220
Cost of Sales	<u>103</u>
Gross Profit	117
Selling Costs	30
Admin Costs	20
Depreciation	<u>8</u>
Profit <u>Before</u> Interest & Tax	59
Finance Costs	<u>5</u>
Profit <u>Before</u> Tax	54
Tax Expense	<u>20</u>
<u>Net Profit</u>	<u>34</u>

Depreciation.

- In calculating accounting profit we deduct investment expenditure gradually over time in the form of depreciation.
- That seems reasonable. We are “using up” an asset gradually over time, so we are expensing it gradually over time. To a great extent the pattern of depreciation is up to you.
- BUT the tax man doesn't like you to have that much freedom!

Capital allowances.

- The tax man defines tax allowable patterns of depreciation for certain types of capital expenditure.
- In the UK these are known as capital allowances.
- So, in calculating taxable profit from accounting profit a basic adjustment is: add back your depreciation figure and subtract the tax man's capital allowances.

Eligible capital expenditures.

- Plant & machinery.
- Know how.
- R&D.
- Renovation of business premises.
- Patent rights.
- The key distinction is between assets which perform an active function (apparatus) and those which have a passive function (setting).

How do you tell the difference?

- Capital Allowances Act 2001.
- Case Law.
- Examples:
 - A synthetic football pitch v. a football stand.
 - Decorative floor and wall tiles in a restaurant v. pictures on the walls of an hotel.

Buildings.

- Buildings – not any more!
- Thermal insulation of a building - yes .
- Integral features of a building (electrical systems, water systems, lifts etc) - yes.
- Building alterations incidental to installation of plant and machinery - yes.
- **ACTION POINT: detail that investment expenditure.**

Tax calculation.

<u>Tax Effects of Capital Allowances</u>							
Tax rate	20%						
CapEx	500	£000					
Depreciation	5	years straight line.					
Capital allowances	100%	first year allowance.					
	0	1	2	3	4	5	
Revenue		1000	1250	1500	1500	1000	
(Non Depreciation) Costs		400	575	750	750	400	
Depreciation		100	100	100	100	100	
Accounting Profit		500	575	650	650	500	
Apparent Tax		-100	-115	-130	-130	-100	-575
Taxable Profit		100	675	750	750	600	
Actual Tax		-20	-135	-150	-150	-120	-575
Difference		80	-20	-20	-20	-20	0

Tax payment comment.

- The totals of apparent tax and actual tax are the same. Only the timing has changed.
- In this case the capital allowance system benefits us.
- Government uses the tax system as a policy tool. It gives generous capital allowances to the kinds of capital expenditure it wants to encourage.
- But, the government can change its mind.

The annual investment allowance.

- The tax system in the example has characteristics of the current UK system:
 - 20% tax rate.
 - In the period April 2014 to end December 2015 up to £500,000 investment in plant and machinery qualifies for a 100% annual investment allowance (AIA).
- The AIA is available as a first year allowance (FYA).

But the government can change its mind.

- Pre Jan 2013, AIA = £25,000.
- Jan 2013 - April 2014, AIA = £250,000.
- April 2014 – December 2015, AIA = £500,000.
- After December 2015 “could drop, but unlikely to go back to the £25,000 level”.
- **ACTION POINT:** Perhaps that investment spend needs bringing forward.

Other capital allowances.

- First year Allowance of 100% on certain green technologies e.g.:
 - Energy saving and water-efficient plant and machinery.
- First year allowance on capital expenditure on R&D.
- For the rest - writing down allowance at 18% per annum or 8% depending on which “pool” the asset goes in.

The pools.

- Most general plant and machinery goes into the **main pool** and attracts 18% writing down allowance.
- There is a **special pool**, for some (high emission) cars and “integral features” of buildings, etc which attracts 8% writing down allowance.
- These are reducing balance calculations (but a \leq £1000 pool can be claimed in full).

Combining capital allowances.

- Suppose we have a capital expenditure of £750,000.
- £300,000 of which is factory machinery and office equipment (18% reducing balance).
- £450,000 of which is “integral features” of a building (8% reducing balance).
- AIA of £500k is available.
- **ACTION POINT:** think where that AIA is best used.

Treatment of unused allowances.

- What happens if, in a given year, you have profit of £200k before deduction of capital allowances, and £300k of capital allowances are available?
- Unused allowances could be used to reduce current taxable profit elsewhere in the organisation.
- (or) carried back to offset an earlier period's profit and hence generate a return of tax already paid.
- (or) carried forward until profit is sufficient to make use of them.
- Possibilities have varied over time.

R&D allowance(s).

- As has been said capital expenditures involved in R&D attract a 100% FYA.
- But Research and Development Relief from corporation tax is broader than this.
- We are now going to spend a bit of time looking at R&D relief from corporation tax for SMEs because this also gives tax relief on revenue expenses.

To benefit from R&D relief to SMEs you must....

- Be liable for Corporation Tax (not as easy to identify as you might think).
- Be a “going concern”.
- Have fewer than 500 employees and:
 - EITHER annual turnover \leq €100 million.
 - OR a balance sheet of \leq €86 million.

... and you must have an R&D project.

- A project which “... seeks to achieve an advance in overall knowledge or capability in a field of science or technology through the resolution of scientific or technological uncertainty.”
- The key point is NOT JUST NEW TO YOU.
- There is scope for “interpretation” here.

The potential benefits.

- R&D related (detailed rules here) wages, materials and utilities costs are of course already deducted from revenue when calculating taxable profit.
- Now you can deduct 125% of those costs again before coming up with taxable profit.
- If tax losses are produced then, as usual, carry back one year, or carry forward alternatives are available.

Another alternative use of a R&D based tax loss.

- Assume no profits in previous year.
- Rather than carry forward tax losses until they can be offset against future profits.
- You can take a tax credit – a cash payment from HMRC – to recoup PAYE and NIC.
- **ACTION POINT: Are you in the R&D business?**

You need expert advice.

- I know enough about tax to know the kind of questions to ask an expert, but I'm not an expert.
- Luckily for us there are experts willing and able to help.
- Let me now introduce Chris Bond from BDO's Nottingham office.