

Save tax - and feel good about it

This month, I am inviting those of our readers who run a business with me on an arduous journey to the moral high ground. It's not an area that business people tend to be very used to – not, in my view, because standards of right and wrong are any less marked in the business community as compared with employees and those dependent on the income of others, but because we business people are used to being treated either as if we were crooks or the next worst thing. So I hope this month's article will give a lot of us some pure mountain air to breathe.

Don't run away with the idea that this is just another moral diatribe, short on useful advice and information. In the course of what follows, I hope to show you how, in running a business, you can save tax – and feel good about it.

First, though, the case for the prosecution. It's very much the case that most talking and thinking about tax these days is done from the point of view of HM Revenue & Customs (HMRC), that is the people who have a particularly acute angle on the raising of the most tax possible, as soon as possible. The view of HMRC overflows into a particularly simplistic (in fact, much too simplistic) view, expressed in some magazines and newspapers, that we have some kind of moral duty to pay as much tax as possible as soon as possible.

The next word in this article has been excised on the grounds of this being a family paper!

Presumably, if this view were correct, anything you do that resulted in your paying less tax, or paying tax later, would be morally wrong; so, how about the old favourite example of giving up smoking, or working less hard? The government would certainly get less tax if you did either of these things, and therefore would have less to spend on government services (most of which we haven't asked for) blah, blah, etc., etc.

But the case for the defence isn't just that this view about paying as much tax as possible as soon as possible has inherent contradictions; it goes further than that. In fact, there are times when it is either clearly not the wish to the legislation that this should happen, and secondly there are times when it is clear that it is not public policy that this should happen. But on to specifics.

The optimum business structure?

First, I need to set the scene, and to do this I will use the concept of a 'typical' business. Of course, there is no such thing, but businesses that are managed by their owners (the vast majority of them, numerically) do have a lot of features in common, and while there is no optimum business structure that can be made to fit all businesses, or even all Owner Managed Businesses (OMBs), what follows does form a good basis. The peculiarities of businesses in individual instances can be dealt with by modifications or additions to this basic structure.

OK, then. The structure I am thinking of is (regular readers won't be surprised to learn) a limited-liability partnership (LLP), and not just an LLP pure and simple but an LLP that includes, as one of the members, a limited company. In the very simplest possible incarnation of this structure, Mr A owns the whole of A Limited's shares, but A and A Limited are 'partners' in an LLP. The LLP carries on the trade, not the company, and the LLP owns all the necessary assets to carry on the business.

Now, with this toolkit in our backpack, let's start our climb to the peaks of moral self-satisfaction.

The right amount of tax

Hopefully, the concept of a partnership that includes both individuals and companies as members is a relatively straightforward concept to grasp. There's another concept, much favoured by the Revenue (see its website, for example), that, in contrast, is not at all easy to grasp. In fact, personally, I find it quite baffling. This is the concept of 'the right amount of tax'.

In fact, I was perhaps being a little disingenuous in describing the concept as baffling. In my opinion, it's not so much baffling, as completely absurd. I hope to make good this view in what follows.

1. Employ yourself

Is there anything particularly sensible, in your view, in the idea of someone employing themselves to do something? An employer is somebody who makes

use of the services of an employee on the basis that that employee is effectively, in old-fashioned language, his 'servant'. He is required, all the time he remains an employee, to do as he is told. So how can you reconcile this with the tax fiction that is created where you own a limited company and are also involved in its business?

The fiction is that you are by definition a director of the company even if you aren't actually formally an officer. Therefore, tax treats you as if the company were your boss and you were the servant. Ridiculous? HMRC doesn't think so! In fact, the Revenue imposes a rule that you are treated as within the employment tax and, crucially, national insurance, code in all circumstances, regardless of the fact that you may really be the main or even only person driving the business along.

Earned income you take from the company is therefore subject to national insurance deductions at the much higher employee rates, even though the reality of the situation is that you are self-employed. The worst effect of this treatment (of you being an employee of your own company) is the imposition of 'employer's national insurance' at 12.8% on all your earnings, including benefits in kind. I put the phrase 'employer's national insurance' in quotation marks because, as far as I can see, this label is a complete misnomer: in other words, a deliberate lie. The words 'national insurance' imply that the employer contribution goes into some kind of pot or fund for the employee, to pay him in the event of sickness or retirement. Not so. Employer's national insurance

gives rise to no entitlement to benefits at all, and can therefore be seen as being no more than a payroll tax.

So why bring yourself within the scope of payroll tax when you're really self-employed? Is avoiding a financially punitive absurdity immoral? If so, anyone who operates through any kind of partnership structure, unlimited or LLP, is, I accept, doing a wicked thing.

2. Paying through the nose on retained profits

Countless governments ago, for some reason, which is lost in the mists of time, it was decided that limited companies should pay a lower rate of tax, generally, than individuals on trading profits. Currently, a company pays 21% corporation tax on profits up to £300,000, and the top rate of the tax is 28%. Individuals or partners being credited with the same profits from a business, by contrast, pay 40% tax (and 1% national insurance) on profits in excess of just over £40,000.

What's the reason for this tremendous difference? Well, I can only think of one, but that is actually quite a sensible one. The reduction in the tax exposure on trading profits can in fact be seen as no more than a deferral, in lots of instances. If the individual owners of the business take out the profits by way of dividend, a further tax charge arises, assuming the shareholder is a higher-rate taxpayer. So there is an incentive to retain profits in, rather than extract them from, the business, because that way you pay a lower rate of tax. And surely this is likely to be the reason for these lower company tax rates?

In a straightforward partnership, though, without a company partner, the converse is true, and is a problem. Partners are chargeable to income tax on their profit shares whether or not they extract them from the business, and therefore are likely to be bearing 41% rather than, in the case of smaller businesses, 21% even on their retained profits. Having a company partner to retain the profits in avoids this problem, because if you attribute profits to the company members they bear 21% not 41%. Is that unfair or immoral? It's only doing the same, effectively, as everyone who runs their business through a limited company and retains some profits in the company in order to plough them back into the business.

3. Pay tax on more than you have had

The Revenue's concept, and indeed Gordon Brown's concept, of 'the right amount of tax' definitely includes paying tax on more than you have actually had out of your company, where we are talking about the 'benefit in kind' of using a company car.

In the old days, there was a system, albeit a rather rough-and-ready one, that was intended to tax you, as an employee of the company, on the benefit you were receiving by being able to use the car for private motoring. But this system wasn't good enough for Gordon Brown. Instead, he introduced, some years ago now, a system whereby company-car drivers are punished for driving at all.

Consider the way the rules work: a notional 'income' equating to anywhere in the range of 15% to

35% of the list price of the car when new is taxed on the individual, and national-insuranced on the employer company. Unlike the old system, there is no discount from the original list price if the car is an old one, and the tax charge takes no account at all of how much actual private motoring or business motoring you do.

The most absurd situation is therefore where you have a very old car in which you do very little private mileage. One private mile in the year is enough to trigger the whole charge, and no PAYE inspector is ever going to believe that you don't do any.

So how about this for a wicked, subversive idea? You actually pay tax on the true private mileage, and all the costs of running a car for business are claimed as a deduction against your taxable profits!

With a reasonably sized car, I calculated recently that the driver would be paying about £400 tax if he operated his business through a partnership or LLP structure, and about £15,000 using a company structure. Which of those is the right amount of tax?

The alternative to having a company car, if you are unlucky enough to be an employee, is to run your own car on business and charge the company 40p per mile (or 25p per mile over 10,000 miles in a year). This is only a solution to the problem if your car costs as little as 40p a mile to run, though. This is the maximum you are allowed to claim tax-free, even if your car (as the vast majority do) costs much more than this to run. So Gordon Brown has introduced a deliberately unfair system, where you are forced to subsidise the

business's motoring costs out of your own personal highly taxed and national-insuranced income.

To sum up, the partnership structure stands for fairness; the company structure, for rank unfairness.

4. Pay tax twice on the same gain

Does anyone think that paying twice on the same money is obviously fairer than paying tax once? If so, I think they need counselling, but I am not quite sure where this is available! Surely, if anything in tax is either fair or unfair (which is a highly questionable idea in itself), surely it is fairer only to pay tax once.

I expressed the view, a few paragraphs ago, that there was a reasonably sensible policy principle involved in companies paying a lower rate of tax on their profits than individuals do, but I am quite baffled by the hugely greater tax that companies pay on capital gains. Most businesses have some kind of asset subject to the capital gains tax (CGT) regime, even if it is only trading goodwill, and, not to get too bogged down in the details, an average rate of tax on a company's gains, including the second charge to tax when the net-of-tax proceeds are paid out to the shareholders, is 41%. Individuals making the same gain would pay either 10% or 18%, amongst other reasons, because they only pay tax once.

So the structure involving an LLP with a company in partnership enables you to arrive at what presumably the government regards as a fair result, that is gains are chargeable to CGT at 10% or 18%.

5. Pay tax on selling an asset to yourself

If you sell an asset to your own company, even if you own it 100%, you are treated as having made a capital gain and have to pay tax on that gain based on the sale proceeds which the company pays you. Put that asset into an LLP with the company as one of the partners, in contrast, and, providing you get the partnership agreement right, there is no tax to pay. Is it wrong not to trigger a charge on assets that effectively remain 100% within your personal ownership?

6. Take the business with you to the grave

It may surprise those who have never run a business in their lives to hear that it is actually quite a good thing to bring on the next generation as part owners of the business. The 'next generation' need not necessarily mean members of your family but could be key managers who have both the ability and the drive to push the business forward.

The taxman has two weapons designed to stop you helping your business in this way, and he is certainly not afraid to use them.

The first weapon is CGT. If you give away a proportion of your business, or the shares in your company, the default position, without planning, is that you have a capital gain to pay tax on.

Eh? Gain? But I have just given something away!

Tough luck, matey, says Hector the Inspector. The technical rules say that a gift is a disposal for CGT purposes just as much as a sale is. It's true that you can 'hold over' gains on some gifts of businesses or business assets, but by no means all. You now have to meet a fairly stringent test, which a lot of predominantly trading businesses will fail.

I hope I am not striding too quickly up the mountain path for you to keep up, here. There is a way in which you can avoid triggering a gain at all, using the LLP structure that I briefly described. This is by way of giving some of your capital interest in the LLP to the representative of the next generation. By arranging the LLP agreement correctly, this doesn't need to give rise to a capital gain. This is a big issue, and deserves more space than I have got here. It will be attended to in a later edition of The Schmidt Report.

The Spanish Inquisition's second weapon is the tax on benefits in kind, where shares in a company are given away to an employee, to incentivise him and include him in equity ownership. A tax charge arises based on the market value of the shares given, and it tends to take several years to find out what that is!

Again, by contrast, the LLP structure sidesteps this issue because members of an LLP, as self-employed individuals, are outside the benefit-in-kind regime and don't pay tax on the receipt of an interest in the business. So LLP-based businesses can thrive on the introduction of new blood. In my experience, company-based businesses don't, because the Revenue Howitzer is too big and ugly and threatening.

In my view, anybody who thinks we should just sit back and accept factitious tax charges, where no one has got anything out of the business and all we are trying to do is ensure its future, simply doesn't know what they are talking about. (Or has a not entirely unbiased attitude towards the collection of taxes as an end in itself.)

7. The one-way street or the two-way street?

What would you think of a tax system where you had to pay tax on profits but received no tax relief at all for losses? Is this one-way street fair?

The limited-company structure, particularly in the early years of the business, can achieve exactly that result.

If Mr A, instead of going into partnership with A Limited, had run his business through A Limited (as the huge majority of Mr A's still do) and, as often happens, the company had made start-up losses, then of course the likelihood would be that no one would be funding those start-up losses other than Mr A. And yet there is effectively no relief for them. All A Limited can do is carry its losses forward until the time (if ever) it makes profits from the same trade in the future. If it never does, then Mr A is out of pocket and can't offset the trading losses against his other income, even though he is the one who ultimately has suffered the effect of these losses.

Error! In a partnership structure, the partner funding the losses can offset them directly against his

other income. In the first four years of business, he can even carry the losses back, under a special provision to help start-up businesses, by up to three years.

But the taxman helps those who help themselves. That is, you have to make sure you are in the right business structure or this early-years loss relief is simply barred to you.

So a partnership structure is a two-way street where a limited-company structure can be a one-way street.

8. No profits but lots of tax

I know this sounds like a great idea – from the taxman's point of view. But it's more than an idea: it's a daily reality in countless businesses up and down the country, including many that I have advised myself.

Again, it comes about as a result of carrying on your business through a limited-company structure. You, and perhaps other family members, need to live, and in order to do so you need to take a salary, even if it is only a reduced one, from the company even during a loss-making period. This salary may come out of the previously retained profits of the company, or from capital introduced by investors, or from overdrawing at the bank, but one way or another the supermarket bills need to be paid.

In a period where there are no profits in the company, this salary nevertheless gives rise to tax

and national insurance contributions at the full marginal rates of the individuals. So the government is getting its slice of the cake even when there isn't any cake to cut up.

How much fairer the partnership rules are! Under these rules, even if you take drawings out of the partnership, and even if you are allocated a notional 'pre-share' of profits, if there aren't any profits there you don't pay any tax. It's as simple as that. So is planning to bring about this situation sinful 'tax avoidance'? Personally, I think that if there is any sin involved it's all on the side of those who framed the rules.

Game, set and match

I've probably gone on quite long enough in this article, to get the point home. Basically, what I'm saying, in all the above, is two things:

A partnership/LLP structure can be immensely more tax-efficient than a limited-company structure in a large number of different ways; and

Those tax advantages all derive from fairness, common sense and comprehensible government policy.

Whatever certain of the more extreme zealots in Somerset House may think (and, unfortunately, they seem to be holding the reins of tax policy at the moment), nothing I have talked about could be properly described as the exploitation of loopholes. It's more about making sensible and well-informed

commercial decisions. Dull though that last sentence sounds, though, the tax difference can be truly mouth-watering!

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