

# Tax planning around the “recession” for the small UK business

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Are we allowed to call the current economic crisis a “recession” or do we go as far as “depression”? Whatever the title we must try and ensure tax planning and protection helps with survival of the small UK business.

A sample of the tax planning checklist is as follows:

## **I. Pre-budget report losses – Carry back of tax losses three years (currently a one year window)**

The key points are early identification and claiming of the tax loss and that means now. Accounting concerns will be bad debt provisions, claim for repairs as opposed to improvements, the correct treatment of capital allowances and the write down of balance sheet items where appropriate and how this impacts on possible tax losses.

## **II. Date of approval of proprietor’s accounts – Assess the position at the date the accounts are signed**

A few weeks either side of the date of signing could totally change the accounting and tax treatment of balance sheet values and provisions.

The cut off point can be critical with regard to issues of, say, prudent accounting treatment that results in an insolvent balance sheet but benefits from tax losses to utilise. Factors surrounding the collection of debts change on a daily basis and so too can the solvency of the company and the tax loss to take advantage of.

## **III. Net realisable value (“NRV”) and tax planning**

A clear example of tax planning is that stock should be valued at the lower of cost and net realisable value. How does the owner of the business arrive at “NRV”? A key element here must be the need for a professional valuation and the protection that can be achieved by so doing in convincing the Tax Office in the drop in value.

## **IV. Legal claims – Tax advantage for the small business**

It is said that in a recession there will be greater attempts at legal action, (i.e. civil litigation) against small businesses and the accounting treatment will have to be considered with regard to the fair disclosure and tax treatment. It would be cynical and inappropriate to suggest that some proprietors would welcome evidence of potential legal action that could increase the accounting and tax loss that could then be used to claim the tax refund and then if there is no legal action be possibly written back in future years’ accounts.

Those charged with governance of the business will be making critical accounting and tax decisions. What is the role of the professional adviser?

Reliance on tax advisers, accountants and auditors could be another reason to increase the greater opportunity for civil actions against professionals – the guardians of true, fair and accurate accounting. The

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real shame for all concerned is that honesty, proactivity and genuine client care by professionals could result in greater exposure to litigation for professionals.

#### V. Professional negligence claims – Financial disadvantages for professionals

Professional life is full of irony and one such example is that professionals who try to help clients who are suffering under the strains of the recession could be MORE likely to be subjected to a professional negligence claim. The duty of care owed to the client will need to be defined as will the evidence of requisite skill and care involved in any work carried out. The claimant will have to show actual loss suffered. Great care must be taken and will be needed in defining terms of engagement.

#### VI. Engagement letters for one-off specialist survival work

When clients contact their professional advisers asking for help in the recession it would be reassuring to think that the first matter the professional considers is self-protection but after giving due consideration to the problems raised by the client the next matter to consider is risk management of the work that is required. The starting point is that the terms of the engagement have to be clearly defined as do the risks involved. To whom is the duty of care owed and what is the size of the financial risk in the worst case scenario?

#### VII. Trading whilst insolvent – Unlawful dividends

For the limited company one of the first safety checks in a recession has to be whether there are enough profits built up in the company to allow the directors to authorise payment of dividends when the business is not trading profitably?

Directors must carry out safety checks as to solvency on an ongoing basis. The desire to maximise a tax loss to carry back under the new three-year provisions of the 2009 Pre-Budget Report must be carefully reviewed as must genuine legal claims and resulting provisions against the client company.

If restructuring is needed, will there be a “change of ownership” that can have tax disadvantages regarding the use of losses?

#### VIII. “Change of ownership” and restructuring

“Change of ownership” resulting from the restructuring to help a struggling company has to be given due consideration by the tax adviser. The tax restructuring of struggling companies has to be planned carefully.

Rules that prevent an investment company’s use of its non-trading losses (expenses of management, non-trade loan relationship deficits, or charges) if, after a change of ownership, there is a significant increase in the company’s capital (TA 1988, section 768B(1)(a)) need to be considered. As the number of companies that are incapable of servicing their debt rises in the recession, a fair number of these will have significant interest losses.

A “change of ownership” is defined within TA 1988, section 769 as the acquisition by one or more persons of over half of a company’s ordinary share capital. If this is in fact by more than one person, each must acquire at least five percent. The change of ownership is calculated by comparing any two points in time over a period of three years.

Assuming there has been a change of ownership of a company, there also needs to be an increase in its capital in order for it to lose the benefit of its tax losses going forward. To determine whether this has occurred, it is important to look at TA 1988, Schedule 28A.

A company in hardship that has been forced into a debt for equity swap by its banks as a condition of avoiding a winding-up process, on HMRC’s interpretation, faces the prospect of losing the benefit of its tax losses brought forward – tax losses that could potentially be of enormous value in the company’s survival. The company replaces a non-capital item (bank debt) with a capital item (shares).

The company law implications of the actions of directors (including some thought about the directors’ fiduciary duties and the possibility of financial assistance issues) may need further consideration by both professional advisers and those charged with governance.

#### IX. Summary

Proactive tax planning and protection can help reduce tax liabilities and even result in tax refunds for the small business at a critical time. However, the complexity of solvency, change of ownership and protection against legal claim for the tax planner must be considered. We live in interesting times.

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