Section 4: The difference between your bookkeeping profit and your taxable profit

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Disclaimer

This guide is designed to alert you to some of the major issues you should be considering. It is not a replacement for professional advice tailored to your precise needs and circumstances.

You should always seek the advice of a suitably qualified professional before acting on any of the advice.

And if you would like to speak to us about any of the issues covered in this guide, please feel free to give us a call or drop us an email.

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Are you confused as to how the profit per your accounts never looks like the profit you see from your bookkeeping system?

And then your taxable profit is another figure again?

Well this section will help you understand the differences.

Now you may not think that understanding your accounts is nothing to do with you but you're wrong!!

As this is your business, you need to have a good understanding of what is going on in it.

You're also the one who signs the accounts and tax return and when the taxman comes calling, he won't be talking to your accountant – he'll be talking to you.

So make sure you understand the adjustments made to your bookkeeping profit to produce your accounts and also what has been allowed and disallowed for tax purposes.

And if you understand what's allowable and what isn't, you'll understand even more why it's important to analyse your disallowable expenditure correctly – it's one of the first things the taxman will look for!

And remember, if we're doing your accounts and tax for you, we automatically send you a year end reconciliation showing exactly what adjustments we've made when preparing your accounts and tax.

So if you've got any questions, just let us know.

4.1 Bookkeeping profit to accounting profit

Depending on how good your books and records are, there may be only a few or there may be quite a lot of adjustments to be made to your bookkeeping to prepare your accounts!

However, unless you're audit registered (with a turnover of more than £6.5m as at 2014) then your accountant won't be 'auditing' your books.

Depending on your agreement with your accountant (and how much you pay!) most accountants will take your books and records and assume they're correct. They will then make the most common adjustments – noted below.

We will always let clients know if we spot obvious errors but our fees don't include any type of 'audit'. And that's why we encourage you to use this manual and speak to us during the year so that you can make sure your bookkeeping is bullet proof!

4.1.1 Prepayments

When you post invoices from your suppliers into your bookkeeping package you will post it all in one month. But some of these expenses may relate to after your year end.

We will put an adjustment through to take these costs out of your overheads and post them to the balance sheet.

So this will make your accounting profit greater than your bookkeeping profit.

4.1.2 Accruals

There may be costs which you have incurred but for which you haven't received an invoice or which were invoiced after your year end.

We will put an adjustment through to add these costs to your overheads and post them to the balance sheet.

So this will make your accounting profit less than your bookkeeping profit.

4.1.3 Depreciation

When you buy an asset, you will post it in your bookkeeping software to an asset account.

But what you probably won't do is make any allowance for depreciation.

So we will put an adjustment through to reduce the cost of the asset and this charge will be added to your overheads and post them to the balance sheet.

So this will make your accounting profit less than your bookkeeping profit.

4.1.4 Bad debts

You might have debtors showing on your balance sheet who are never going to pay – for example, they may have gone bankrupt.

We will put an adjustment through to 'write off' these debtors so they no longer show on your debtors report.

This adjustment will be posted to a bad debt expense account in your overheads.

So this will make your accounting profit less than your bookkeeping profit.

4.2 Accounting profit to taxable profit

Having calculated your accounting profit, there will be certain adjustments made to calculate your taxable profit. Again the main areas are noted below.

It is therefore important that you identify these separately so that we can adjust your business tax accordingly.

4.2.1 Non-staff entertaining

You may feel that entertaining your customers and suppliers is a legitimate part of your business – unless you play the game, you won't get their custom.

Unfortunately the taxman doesn't feel the same way and any expenditure on entertaining your customers will not be allowable.

4.2.2 Working lunches

If the Revenue undertakes a PAYE compliance visit you can be sure that they will scrutinise your staff costs.

One matter in particular is the cost of providing staff lunches. Unless they're provided to all the staff (though not necessarily taken up by them) this produces a tax bill for those enjoying the lunch.

The Revenue's starting point is that any meal taken with a work colleague is likely to have personal ramifications so any expenditure on meals has not been incurred "wholly, exclusively and necessarily in the performance of the employees duties" and is therefore taxable on the employee.

There are a few examples where the taxman considers that no tax liability arises on a free meal. For instance if a meal is provided in the course of discussing the employee's contract then HMRC are unlikely to view this as taxable.

You therefore need to demonstrate that social and personal considerations play no part in coming together for a meal. If your spouse works in your business and you take them to lunch you will need a cast-iron excuse for arguing it's for a business purpose (!).

Or if a meal is provided as a reward to just a few staff who have worked hard on a particular project it still may be potentially taxable.

There seems every reason to try and claim a deduction for lunches where the business element clearly outweighs the social side. In-house staff training during a lunch time would be allowed as if staff are expected to attend the meeting and there is some genuine technical or business related session in progress it will be difficult for the Revenue to argue there is any social aspect.

Furthermore you don't have to provide all employees with the same meal to qualify for the exemption (so vegans can be catered for).

If you provide free or subsidised coffee and biscuits for all staff this will be covered by the exemption in the taxes legislation.

4.2.3 Personal clothing

There is a lot of case law around clothing. You may feel that any expenditure on a business suit should be allowable because you wouldn't be seen dead in one if it wasn't for running your business.

But unless the expenditure relates to a uniform which would make you or your staff recognisable outside of the workplace then it isn't allowable. Having a distinctive business logo or business colours may be enough to claim that it's a uniform.

If you decide to provide your staff with clothes which aren't regarded as a uniform, then they will be taxed on the cost of the clothing personally as a benefit in kind and your business will have to pay employer's NI on the cost. However the business can claim a deduction against its taxable profit for both the cost of the clothing and the NI contributions.

However, if you are a sole trader and buy non-uniform clothing for yourself, then generally speaking this will definitely be disallowed. Unless of course you're an entertainer or in the public spotlight!

4.2.4 Parking fines

If you pay for your employees' parking fines, then your employees will be taxed on the cost of the fines as a benefit in kind and your business will have to pay employer's NI on the cost. However the business will be able to claim a deduction in its taxable profit for both the cost of the fines and the NI.

On the other hand, if you are a sole trader and pay your own parking fines, then this will definitely be disallowed!!

4.2.5 HMRC fines and penalties

If you are late paying your dues to HMRC and get slapped with a fine or penalty, then you will not be allowed to claim a deduction for this in your taxable accounts.

In addition, if you incur interest charges on late payment of tax, then whilst this will be allowable if you are a limited company, this will be disallowed if you are a sole trader or partnership.

4.2.6 Gifts to customers

Gifts which contain a conspicuous advertisement for your business are, under certain conditions, allowable for tax purposes.

However, the following conditions must be met:

- the gift must not be food, drink or tobacco, nor should it be a token or voucher exchangeable for goods.
- the cost of the gift (together with the cost of any other such gifts to the same recipient in the relevant tax period) must not exceed £50.

Common examples of allowable gifts are diaries, pens and mouse mats.

The advertisement should be on the gift itself, and not just on the wrapping.

4.2.7 Depreciation

The depreciation charge put through your books when calculating your accounting profit is not allowable for tax.

Instead the taxman will allow you to deduct something called capital allowances.

Capital allowances are also an attempt to spread the cost of an asset over its expected useful life.

However, whilst a business may choose a depreciation policy which reflects how they feel the asset will wear out over the years, capital allowances are set out in the Capital Allowances Act and are subject to changing periodically.

From 1 April 2015 (limited companies) and 6 April 2015 (sole traders and partnerships) businesses are able to claim what is known as the 'Annual Investment Allowance' (AIA) for the first £500,000 of their expenditure on most plant and machinery. **You should be aware though that, this is only a temporary limit and the AIA will be slashed to £25,000 with effect from 1 January 2016.**

You are effectively able to claim 100% of the cost of any new equipment up to the value of £500,000 in the year of purchase. Ordinarily you would have to wait a number of years to get tax relief for the full cost of any equipment purchases.

If any expenditure exceeds the AIA limit then it is dealt with under the normal capital allowances regime.

So broadly speaking this means that the cost will be written off at a rate of either 10% or 20% per annum over the life of the equipment meaning you have to wait longer in order to get the full tax relief (see above).

Also, you should note that for a period of account which is not 12 months then the AIA is proportionately increased or reduced.

You are also be able to claim 100% of any expenditure incurred on what is known as environmentally beneficial plant and machinery.

You need to take care that the expenditure qualifies for the relief and we'd recommend you log onto **www.eca.gov.uk** for further information.

4.2.8 Working from home

Working from home has always been popular but what you can charge your business for this has often been the subject of some debate.

Well, basically you have two options:

1. If you opt to use HMRC's flat rate deductions you can claim a maximum of £312 per annum, though only if you spend at least 101 hours a month working in your home (hardly worth getting excited about is it?!!).

2. You can charge a reasonable percentage of your home costs.

The big question is what constitutes a reasonable percentage of your home costs?

You can take into account all costs related to your home – e.g. mortgage interest, council tax, home insurance, repairs and maintenance, gas and electricity, water rates etc. You then work out what proportion of your home you use for business.

Let's take an example:

> You use one room in your home exclusively for business between 9am and 5pm and the family use it for two hours each night (it's important that the room isn't used exclusively for business all the time as otherwise you might end up paying an element of capital gains tax when you sell your home!!).
>
> Suppose you are at home on average 6 hours during work hours and out at site visits for the remaining 2 hours.
>
> Then you would be able to claim 6/8 of the variable costs (the room is used for a total of 8 hours a day by you and your family and you use it for 6 hours for business use) and 8/10 of the fixed costs (the room is available for business use 8 hours a day out of a total of 10 hours use).
>
> Variable costs are your light and heat, whilst fixed costs are your council tax, insurance etc.
>
> The important issue is the exclusivity of use – you can claim a deduction because there is a time during the day when the room is used exclusively for business.

If you were working from your kitchen table, you probably wouldn't be able to claim as it would be hard to argue that a kitchen could be used exclusively for business during the day.

However, things get slightly more complicated if you are trading through a limited company.

Because you and your company are separate legal entities, it's best to have a rental agreement between you and your company. This needs to be based on the market rents at the time – a sensible way to determine this might be to look at the rents charged by serviced offices in your area.

However, you must remember that the agreement is for non-exclusive use by your company. In other words the office is only available for use by your company between specified hours on specified days – for example, 9am to 5pm on weekdays.

As with a sole trader, failure to properly document and actually stick to the terms of the agreement, may result in you being subject to capital gains tax when you sell your home!!

You will also need to declare the income from the business on your tax return. However, you can offset the costs you incur on allocating the 'office' space to your company (using a similar calculation to the sole trader above). This way not only can your extract profits from your company without paying National Insurance (unlike salary), you should also be able to reduce any potential tax liability on the rental income you receive, to a nominal sum.

Additionally, the company can claim a Corporation Tax deduction for the rent it pays to you.