

TaxZone Newthwire

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Editorial Note

Accepting instructions to act for a small unincorporated business used to be a relatively simple affair. One just prepared annual accounts and a simple tax return and submitted these items to the Revenue, checked Schedule D assessments, advised on tax payments and collected the fee and that was it. It did not matter too much if the accounts were a 'paper bag' job and one had to prepare the accounts from incomplete records.

These principles no longer apply. Government and professional regulation and the advent of self-assessment have changed the whole scenario, and not to the advantage of the client, who is almost certainly obliged to pay a higher fee. So much for advertised government support for the small business.

I shall seek to trace the actions that need to be taken on behalf of the new unincorporated business client in this wire. Some of them are obvious and some points that I will make will be idealistic and probably unattainable in practice.



Regards

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Tax and the Small Business

Accepting the client

After an approach by a small business, what does one do? Well, we are now almost bound by the Money Laundering Regulations, so the first thing to be done is to check the credibility of the client. At the very least evidence must be produced by the client of his or her identity, perhaps in the form of a passport or driving licence. There was a good comment on 'Any Answers' about this, suggesting that this should be done with an apology!

Has the new client come from another accountant? If so, the procedure for transfer of business has to be entered into, hopefully with no problems.

Professional regulation now enters into the picture. What work will be done for the new client? Presumably preparing and submitting accounts and tax returns will be the basic work. But what about Tax Credits, pensions, life insurance and IHT planning? Does the practitioner feel equipped to advise in these areas? And will the work extend to family tax returns? There are obvious 'add-on' services that can be marketed, but the extent of the accountant's responsibilities and liabilities need to be spelt out in the engagement letter.

Some new clients will have employees, and may need help over payroll matters, including PAYE, SSP, SPP and benefits. Will subcontractors be engaged? Will the new client be registered for VAT, and does he or she need help in that respect and/or in the preparation and submission of VAT returns? Once again these duties need to be elaborated in the engagement letter.

Although matters such as employment law, data protection and health and safety are normally beyond the scope of the accountant's expertise, it does no harm to highlight these aspects. Similarly the need for general business insurance should be mentioned. Some accountants will have financial services 'arms' that can deal with insurance matters.

Finally, under this heading, there is the question of the basis of the accountant's charges. This is often an extremely difficult area when dealing with a new client or new business, as one has little idea of the time that the job will take, particularly in the first year. Very often the time taken in the first year bears no relation to the size of the client. Should one expect to write-off some or all of this time in the interests of practice promotion?

Many accountants have now moved over to the fixed fee basis. Whether or not this takes place, payment quarterly or even monthly by the client will be of benefit to both parties, will 'soften the blow' for the client, and recover costs that are incurred by the accountant in the first year. If the relationship does not work out, at the very least some fees will have been recovered before the 'parting of the ways'.

Initial work

The first task will be to make sure that the business has been registered with Inland Revenue NICO within the appropriate three months, and that the proprietor(s) have made arrangements to pay their Class 2 national insurance.

Forms 64-8 should be submitted to the Revenue for the proprietor/partners, and the appropriate tax registration number, and District Office address, telephone number and reference noted.

The question of communication should be discussed with the client. This is vital in all respects. Contact with the Inland Revenue should normally be made by the accountant, who will keep the client informed. If the client interferes with this, it breeds confusion.

Bookkeeping and accounts

Hopefully the accountant will then have the opportunity to discuss the books to be kept by the business before trading commences. In reality this rarely happens, and either the client enrolls sometime after commencement of the business or one is faced by a request to prepare accounts after the first year end and just before self-assessment filing is required.

However the ideal is for an agreement to be reached between the accountant and the client regarding the books and accounts to be kept. This is particularly important if accounts will be prepared by the accountant through a computerised system, when the appropriate bookkeeping system will save both parties money. It should be stressed to the client that inadequate books and accounts will greatly increase both his accountant's fee and the possibility of an Inland Revenue Enquiry, and are now a tax offence.

The requirement of section 12B, Taxes Management Act 1970 regarding the basic books to be kept should also be discussed, which will be a good impetus to the client to co-operate. At the very least records of receipts, payments, purchases, sales and stock are needed, along with retention of invoices and receipts. The client should be made aware of the necessity to retain the books records and vouchers for the statutory period.

VAT matters

The question of VAT registration should be discussed with the new client. Registration may be mandatory. This will affect the bookkeeping and records. The client may need help with at least the first VAT return and possibly help with annual or quarterly returns will be an 'add-on' to the accountant's work for an agreed fee. Annual accounting may be relevant.

Education for the client as regards what VAT can be claimed as input tax and those items that are disallowable will also be necessary. One hopes that the business is straightforward and will not involve partial exemption of outputs etc., but that possibility needs to be faced.

The client should be made aware of the draconian powers of Customs & Excise, and also that Customs officers have the right to visit the business. However, it should be stressed to the client that if he or she ever has a sudden visit by Customs officers, then the first thing that needs to be done is a phone call to his advisers. Facilities should not be extended or questions answered until the accountant or perhaps a solicitor are present.

Tax payments

Part of the education for the client should be to make him or her aware of the basics of self-assessment and the system for tax payments. If the business is commencing on, say, 1 April 2004 with an accounts year to 31 March 2005, then the first tax payment is due on 31 January 2006.

That payment will comprise the year's tax for 2004/2005 and one half of the tax due for 2005/2006. Thereafter tax is due half-yearly. It is essential to encourage the client to reserve funds for tax payments, particularly the first one. Obviously it is difficult to forecast income and profits at the beginning of a business, but regular communication might overcome this problem. Ideally funds should be deposited in a separate bank account as a reserve for tax payments. The necessity to communicate if profits are sharply reduced in any year needs to be emphasised, so that a reduction in the half-yearly tax payments on account can be requested.

While the technical intricacies of overlap relief are likely to be beyond the client's comprehension (if not the accountant's), it is a good idea to discuss the consequences of choosing comparative year-ends for business accounts, and their effect on tax payments and their dates both now and in the future.

Business expenses

Some discussion as to what expenses are and those expenses that are not allowable for tax purposes is also useful at an early juncture. An unincorporated business has no legal restraint on how its funds are disbursed, but the proprietor should have some appreciation of personal payments, private use and drawings. It is useful to the accountant if private payments are recorded as drawings. Specific heads of expenditure that are worth discussing are:

Wife, husband's or partner's salary

In many instances the business will be owned by one partner to a relationship, while the other gives some assistance. Where a salary is paid to the other partner, it needs to be stressed that:

- The payment must be justified in terms of time spent and type of work undertaken.

- Payments must actually be made, rather than an adjustment through drawings at the year-end.

In some instances operation of a PAYE scheme will be necessary, and NIC consequences should not be overlooked.

Use of home

Some businesses will be based at the client's home. It should be explained to the client the basis on which a proportion of home expenses can be claimed for tax purposes. The client should be advised never to use one room exclusively for business purposes, in order to preserve complete CGT exemption.

Dual purpose expenditure

Particularly if the business is based at home, there will be an apportionment of some expenditure between business and private. One way of dealing with this is for the total expenses to be included in the accounts, and then a necessary 'add-back' made in the tax computation. The alternative is to debit the private proportion to drawings by a journal entry, but this avoids disclosure on the self-assessment tax return and, in my view, is less advisable, although it may distort the accounts for other parties.

The client should be made aware of the principles regarding 'private use', and also, in trades where this is relevant, 'own consumption'. The client will find it hard to believe that own consumption has to be valued at full market value!

Stock

The client should be made aware that, in cases where materials, food and other supplies are dealt with, that a stock valuation is required at the year-end, and that this should be valued at cost or net realisable value, if less than cost.

Drawings

The client should be encouraged to record his drawings by a weekly or monthly transfer to a private bank account, if at all possible. It is far better if personal payments in addition are not made through the business account, but that is often difficult to achieve.

This might also be a good time to mention the powers of the Inland Revenue, and the possibility of an Inland Revenue Enquiry at some point, even if it only an aspect enquiry or a Random Audit. The possibility that the Revenue might request private side documents and information in those circumstances should be mentioned.

Motor and travelling expenses

Most businesses will use a business vehicle, whether it is a car, lorry or van. The client should be made aware that a tax claim can be made for depreciation in the form of capital allowances. Also that the cost of petrol, repairs and maintenances, DVLC licence and insurance is claimable.

Conversely the basis of 'private use' needs to be explained, where a car is used for business purposes. In such circumstances the client should be encouraged to keep a mileage record, even if only for a representative period. It is unrealistic to expect all clients to keep a full mileage record for all journeys!

The PAYE Audit

In cases where the business has employees and a PAYE scheme is operated, it is wise to mention the fact that a PAYE Audit and/or Schedule E Compliance Visit is likely to occur at some point. My view is always that the professional adviser should be present on such an occasion, if the client is prepared to fund this additional representation.

If this is not possible, the client needs to be briefed regarding such occasions. Only those books and records that are actually required should be produced. Revenue personnel should be given the use of a room (if possible) with no other indications of the affairs of the business present. Most importantly, proprietors and staff should refrain from entering into informal conversation about any aspect of the business with the Revenue staff. Such an occasion is always a formal one for Revenue staff!

Fee protection insurance

The subject of professional fee protection insurance should be raised at an early stage. This is not a marketing initiative, although some might perceive it as one. Failure to acquaint the client of the possibility of such insurance could be a breach of professional ethics and also lay the accountant open to a charge of professional negligence if an Inland Revenue Enquiry had to be funded solely by the client without the client being aware that insurance cover could have been arranged.

Client communication

The accountant also needs to communicate with the client during the business year. Some practices send out client newsletters, particularly at Budget time. It is helpful if the client is aware of important dates for tax filing, payment and claim purposes.

Much if not all of the information mentioned in this wire should be communicated to the client in writing. One cannot expect a 'lay person' to take on board all that is at stake in the tax world.

Office administration

Similarly the practitioner needs to make sure that his or her office reminder system is adjusted to take into account the important tax dates involving the new client. These will include the date when the books and accounts are requested for accounts preparation, accounts and tax return filing dates and tax payment dates.

End of year work

This then leaves the end of year work. One assumes that the business accounts will be submitted to the Inland Revenue in conjunction with the self-assessment tax return. In my view this is best practice.

I also believe that a full set of accounts should be prepared for every client, including a balance sheet. This even applies to businesses with an annual turnover of £15,000 or less. The balance sheet may be minimal, and include little more than a motor car, bank account, debtors and creditors, the capital account and drawings, but is part of making the fullest possible disclosure to the Inland Revenue.

Disclosure of the total of drawings may prevent at least an Inland Revenue aspect enquiry based on a suspicion of insufficiency of funds. Equally a tax computation should show clearly the private use 'add-backs', and, particularly in the first year, any explanation should be written in the 'white space' of the tax return, in addition to a mention in an accompanying letter.

Co-operation from the client or not and the practice work schedule will decide whether the accounts and tax return is submitted prior to 30 September or between that date and 31 January. Whatever procedure is undertaken, it is essential that, when accounts and tax returns are finalised, the client is given an estimate of the tax due for the year, as well as the balance due on 31 January and estimated payments on account on 31 January and 31 July.

Finally there is the fee to collect, and hopefully a satisfied client and practitioner. However, life is not always like that!

Conclusion

If one reads the contents of this wire a valid question is 'are the government really encouraging the formation of small businesses?' Because of the amount of 'red tape' involved the answer must be 'no', even in the case of an unincorporated business.

In addition, informing the client of all that needs to be taken into account at one 'sitting' would be a positive disincentive to go into business. The details should probably be 'drip fed' to some extent, and confirmed later in a series of letters, otherwise he or she will be put off self-employment for life!

Ask a question

Readers with a current case should post their query in Any Answers.

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