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SWP 13/88 TAXATION AND SMALL BUSINESS

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INTRODUCTION

Often the biggest worry for the small businessman is taxation. Not only must he account for the tax he owes on his own earnings, but he must also act as unpaid collector of taxes from his employees and customers. The sheer complexity of the tax system and the volume of forms that regularly need to be filled in can make him wonder whether he will have any time left for the real business problems he faces.

Most businessmen will have to deal with three separate departments:

- INLAND REVENUE: for income tax, corporation tax and National Insurance payments.
- DEPARTMENT OF HEALTH AND SOCIAL SECURITY: for National Insurance matters.
- CUSTOMS AND EXCISE: for value-added tax (VAT).

The national tax-take reflects the importance of these different departments. In 1985 UK tax revenues totalled £135 billion. Table 9.1 shows how this was split between the different forms of taxation. You may draw some interesting conclusions from these figures. First, you may be surprised by the relatively small contribution of corporation tax. In fact, of the £9.1 billion, £3.8 billion (or 42 per cent) represents advance corporation tax which is really a withholding tax on dividend payments. So the true tax contribution of incorporated businesses is even less than it appears.

Table 9.1 1985 Tax Revenue

	£ billion	%
Income Taxes		
Income Tax	35.4	26.2
Corporation Tax	9.1	6.7
Petroleum Revenue Tax	7.4	5.5
National Insurance	24.1	17.9
Expenditure Taxes		
Value added tax (VAT)	21.0	15.5
Drink & Tobacco	8.5	6.3
Oil	6.2	4.6
Miscellaneous customs & excise	3.0	2.2
Motor vehicle Duties	2.4	1.8
Other Levies	2.1	1.6
Local Rates	13.6	10.1
Capital Taxes (capital gains tax, capital transfer tax)	2.1	1.6
	<u>134.9</u>	<u>100</u>

Source: Central Statistical Office, United Kingdom, *National Accounts 1986* (Blue Book).

As you will see in the following chapter, the tax allowances and incentive to any form of business are quite generous, so with a little careful tax planning, the financial burden of taxation can be greatly reduced.

Second, you may be surprised by the large contribution made by National Insurance. Really National Insurance contributions are just another tax. They are compulsory and not genuine 'insurance'. Over the last 20 years the National Insurance revenue has risen considerably and this tax is now a major burden to any form of business. Not least because the size of the employers contribution is seen by many as being effectively a tax on employment.

The small businessman has the choice of three major forms of business organisation: sole trader, partnership or limited company. The relative tax advantages of these

different trading forms are dealt with later in this chapter. However, the form adopted affects the taxes the small businessman will pay.

As a sole trader, a small businessman is treated as self-employed and liable to income tax on the profits of the business assessed under the rules relating to Schedule DI or DII income. As a partnership, business profits are taxed under the same rules and joint assessment to income tax is raised on the partnership.

As a limited company, the small businessman has to account monthly to the Inland Revenue for the Pay-As-You-Earn income tax due not only on his employees' salaries, but also on his own remuneration. The company must also pay corporation tax on its profits after expenses including salaries or directors fees.

Taxation of the sole trader

Income tax

The sole trader pays income tax just like any individual. The profits on which income tax is assessed are drawn up on Inland Revenue rules relating to what is called Schedule DI or DII income. The basic rate of income tax is shown in Appendix 1. Because most taxpayers are entitled to some personal relief, such as the single person's allowance or married couple's relief, the average rate of income tax is somewhat less than the basic rate. The personal reliefs currently available to individuals are shown in Appendix 1. In addition to these, mortgage interest payable is deductible in full on mortgages up to £30,000.

Taxable income (income after personal reliefs) in excess of a set threshold, usually revised annually, is taxed at higher rates of tax. Appendix 1 shows these higher rates alongside the relevant taxable income band. It also shows the average rate of tax at these income levels. As you can see, while the highest UK marginal tax rate on earned income is 60 per cent, the average rate of tax on that income will be considerably less

than that. Many argue that higher marginal rates of tax discourage earning additional income (the *price effect*), while others argue that higher average rates merely force people to earn more income in order to maintain their after-tax income level (the *income effect*). The weight of the former argument led the government in 1979 to reduce the highest marginal rate of tax from 83 to 60 per cent.

Prior to 6th April 1984 there was a surcharge above the normal income tax rates on investment income, i.e. income mainly from dividends and interest. For 1983-84 this meant a surcharge of 15 per cent, if gross investment income exceeded £7,100, and thus the top investment income rate was $(60+15)=75$ per cent. This additional rate no longer applies to individuals.

Schedule DI and DII income

The sole trader may have income from a number of different sources. The following classes of income will be included for each tax year:

Schedule	Source
A	Land and buildings
B	Woodlands
C	Income from government securities
DI & II	Trades and professions
DIII	Interest
DIV & V	Overseas securities and possessions
DVI	Miscellaneous
E	Earnings from employment (Pay-As-You-Earn: PAYE)

Each source of income has different rules relating to it. This section concerns only Schedule DI and DII income: the income that the small businessman will generate from his business activity.

The basis for arriving at taxable profits are the accounting profits for a particular year. However, there are certain business expenses which are not allowable for tax purposes. Equally there are certain allowances which are not related to normal accounting measures

of income. This is only to be expected since tax officials are trying to enforce statutory regulations with the least possible ambiguity and accounting profit is open to a certain amount of manipulation.

Generally taxable profit takes into account all sales and increases in stock values during a 12-month period. Against this, a business may set all expenses of a revenue nature (as opposed to capital nature) which were incurred *wholly and exclusively* for business purposes, together with capital allowances for capital expenditure. This is considerably more liberal than the expenses allowed against the taxable income of business employees which have to be *wholly exclusively and NECESSARILY* incurred for work purposes. Thus, for example, the cost of travel from home to work is not allowable for employees (taxed under Schedule E, PAYE) but would be allowable for a sole trader if his home was also his 'place of business'. A list of those expenses typically allowable against Schedule DI/II income is given in Table 9.2 and some non-allowable expenses are shown in Table 9.3. Neither list is exhaustive.

Table 9.2 Schedule DI/II allowable business expenses

1.	Cost of goods and materials bought for resale
2.	Wages, salaries and pensions paid to employees plus staff welfare costs
3.	Running costs of buildings (rents, rates, etc.)
4.	Carriage, packing, delivery and discounts, etc.
5.	Printing, stationery, telephone, postage, etc.
6.	Insurance, advertising, trade subscriptions
7.	Redundancy payments to employees
8.	Professional and legal fees of a revenue nature, e.g. audit, bad debt collection.
9.	Various taxes and National Insurance payments
10.	Travel and subsistence expenses for business trips but <i>not</i> the cost of travel between home and office (unless you also do business from home)
11.	Entertaining staff and overseas customers (or UK customers seeking overseas contracts), but <i>not</i> UK customers
12.	Gifts incorporating the company name <i>only</i> if the value to each recipient is under £10.
13.	Bad debts and specific bad debt provisions
14.	Running expenses of motor-vehicles, excluding any proportion for private use
15.	Repairs to plant and machinery etc.
16.	Interest and hire-purchase costs
17.	Pre-trading expenditure of a revenue nature
18.	Capital allowances

Table 9.3 Schedule DI/II non-allowable business expenses

1.	Expenses for private or domestic purposes; where there is an element of business use, then a proportion will be tax-allowable - for example, if a private dwelling is used for business purposes, the allowable proportion will not normally exceed two-thirds*
2.	Capital expenditure and depreciation of plant, etc. (there are special rules relating to capital allowances)
3.	Loss not connected with the business (there are special rules relating to losses arising from the business)
4.	General provisions (e.g. for bad debts); only specific provisions are allowable
5.	Drawing from the business
6.	Payments of income tax, capital gains tax or corporation tax, etc.
7.	Any annuity or other annual payments (other than interest)
8.	Professional fees of a capital nature (e.g. relating to a new lease, designing a new building, advising on the purchase of a new business)
9.	Any royalty payment from which you deduct income tax
10.	Fines and related legal expenses
11.	Political donations
12.	Charitable donations unless entirely for business purposes
13.	Entertaining UK customers

* However, in this case the dwelling may become liable to capital gains tax on disposal.

Stocks, consisting of raw materials, manufactured components, part-finished products and unsold finished goods, are an important element in the calculation of business profit. Profits are increased by any excess of closing stock over opening stock and decreased by any deficit. It is obvious that stock valuation affects profit. Valuing opening stock more generously than closing stock can therefore decrease profits. Consequently the Inland Revenue normally insists that opening and closing stock is valued on the same basis. The normal basis is the lower of cost or net realisable value. Cost is normally taken to include direct overheads and possibly an element of indirect overheads. The general rule is that identical items should be identified on the basis that the earliest purchases were sold first (FIFO basis: see Chapter 12). 'Net realisable value' is what it is estimated would be obtained if the stock were sold in the normal course of business, less any expenses relating to the disposal.

Capital allowances

As already stated, book depreciation charged in the financial accounts and capital expenditures are not allowable expenses for tax purposes. In their place the government has substituted a system of capital allowances which in most cases is more generous than the normal book depreciation accounting treatment. Therefore, in the United Kingdom, unlike many foreign countries, a business's book depreciation policy does not affect its tax position.

The current rates of capital allowances are shown in Appendix 1. The capital allowances are computed according to the assets purchased and used in the annual accounting period. For example, if a sole trader were to purchase £5,000-worth of plant or machinery in the accounting year ending 31 December 1987, he could obtain capital allowances on the £5,000 spent in the tax year when these profits are assessed (see the following section on the basis of assessment). The cost of the plant and machinery purchased in the year is added to the tax written-down value of plant and machinery

purchased in previous years (that is, original cost less allowances in previous years). The capital allowance is given on the resulting balance in this 'pool' of assets.

The allowance for plant and machinery applies equally to new or second-hand equipment. Vehicles designed to carry goods such as lorries and vans and those for hire to the public such as taxis are treated as plant and machinery.

Cars costing under £8,000 receive the normal annual writing down allowance and are put into their own 'pool' for calculating the allowance. However, tax law discriminates against the extravagant businessman who purchases vehicles costing over £8,000 and the allowance is restricted in any one year on each vehicle to £2,000. If the sole trader uses his car partly for private purposes, the Inland Revenue will probably restrict the allowances, allowing only a certain percentage of the capital allowance to be offset against the taxable profits of the business.

For example, if you were to purchase a car costing £10,000 and the Inland Revenue directed that 20 per cent of the use of the car is for private purposes, then the capital allowance available to the business would be as shown below:

	Year 1	Year 2	Year 3
Total allowance	£2,000 (restricted)	£(10,000-2,000) x 25% = £2,000	£(10,000-4,000) x 25% = £1,500
Available to the business (80%)	<u>£1,600</u>	<u>£1,600</u>	<u>£1,200</u>

Notice the allowances in years 2 and 3 are based upon 25 per cent of 'written-down' value. That is, the net asset value after previous allowances.

When you sell an item of plant or a vehicle, the excess of the sales receipts over the tax written-down value is taxed. Cars costing over £8,000 are dealt with individually. In the previous example, if you were to sell the car for £5,000 in year 4 the tax written-down value would be £4,500 (£10,000 - £2,000 - £2,000 - £1,500), and the total 'balancing charge', as it is called, would be £500 x 80 per cent = £400 (remember private use). Cars costing less than £8,000 and plant and machinery form two separate 'pools' and cash receipts are deducted from the appropriate 'pool's' *total* tax written down value.

Since the phasing out of 100% First Year Allowances a 'balancing charge' is not likely to arise unless all assets in a group are sold, e.g. on cessation of business.

If you buy plant, machinery or vehicles on hire purchase, the business is entitled to the full capital allowance on the capital portion of the total instalments as soon as the asset is brought into use. The interest portion is allowed against business profit as respective instalments are paid. If assets are leased, then only the lease expense is allowed against business profit as paid. Generally the capital allowances on leased assets go to the institution which leases out the asset.

In Enterprise Zones expenditure on industrial and commercial buildings attracts 100 per cent initial allowance although less than the full allowance may be claimed in which case 25 per cent writing down allowance is available (straight line basis).

Basis of assessment: tax payments

Employees, paying PAYE tax, are assessed on income in the year in which they receive it. This is called the current-year basis of assessment. *Sole traders and partnerships* are assessed on what is called the preceding-year basis of assessment. This can have

important cash-flow implications for a business. On the preceding-year basis a business normally pays tax based upon the earnings during the accounting period which ended during the previous tax year. A tax year runs from 6 April to the following 5 April. Thus the 1987-88 income tax assessment is based upon earnings in the accounting period which ended in 1986-87. This tax would be paid in two equal instalments on 1 January 1988 and 1 July 1988.

For example, if a business has its year end on 5 April (the tax-year end), then the 1987-88 assessment would be based upon the profits for the accounting year ending 5 April 1987. The first payment would be made 9 months after the accounting year end, on 1 January 1988. If a business has its year end on 31 December, then the 1987-88 assessment would be based upon the profits for the accounting year ending 31 December 1986 - a delay of 12 months for the first tax payment.

However, if a business has its year end on 30 April, then the 1987-88 assessment would be based upon the profits for the accounting year ending 30 April 1986 - a delay of 20 months. Clearly the choice of 30 April as an accounting year end has the greatest tax cash-flow advantages. But do remember that other factors need to be considered. For example, you may consider it important to choose a year end when your balance-sheet looks most impressive to your bank manager.

What is clear is that careful choice of accounting year end can yield significant cash-flow advantage to any business. Effectively tax payments will be made in depreciated pounds at a time when income will probably be higher (if only because of inflation). A business can change its accounting year end to take advantage of these provisions, though special rules apply. Special rules also apply to opening and closing year of a business.¹

¹ The special rules that apply on starting a business are:

First Tax Year	assessment based upon profits from the starting date to 5 April following
Second Tax Year	assessment based upon first complete 12-month trading
Third Tax Year	normally on a preceding-year basis; if a full preceding year does not exist, then profits for the first 12 months, again.

The taxpayer has the option to elect that the assessment for *both* the second and third years be on the actual profits for those tax years (6 April-5 April) rather than on the above basis.

For example if I start trading on 1st September 1986 and make up my accounts to 30th April each year, my assessment would be:

Tax Year	Assessment based on profits	Paid
1986-7	1 September 1986-5 April 1987*	on agreement of assessment
1987-8	1 September 1986-31 August 1987 (1st 12 months)	As above
1988-9	1 September 1986-31 August 1987 year)	January, July 1989 (no full preceding
1989-90	Accounting year ended 30 April 1988 (preceding year)	January, July 1990

* This can be expected to be delayed until the first set of accounts has been prepared and my first accounting period will end on 30 April 1988.

For the year in which trade is permanently stopped the assessment will be based upon the actual profits from the previous 6 April until the date of cessation. The Inland Revenue will normally exercise its right (if it is beneficial) to make additional assessments to cover any excess of *actual* profits for the two preceding *tax years* over the normal preceding-year basis of assessment.

Relief for losses

Of course everybody, including the taxman, hopes that your business will trade profitably. However, any business can have its bad patches - particularly in the early years as the business is getting off the ground. Also remember that with the generous

stock relief and capital allowances it is possible to trade profitably and still end up with a tax 'loss'.

If your business makes a tax loss you may set that loss against:

1. Your other income for the tax year *in which you suffer the loss*. The order of set-off is important. First, it is set against your other earned income, then your unearned income, then your wife's earned income, then her unearned income. For example, if you make a tax loss for the accounting year ending 30 April 1986 (assessed 1987-8) you set it first against other income for 1986-7. (This includes business profits in this year.)
2. Your other income for the following tax year. Continuing our example, the following tax year is, of course, 1987-8.
3. Any unrelieved loss may be carried forward indefinitely and set-off against profits from the *same* business.

The above loss relief must be claimed by the business and the claim made within two years.

Special loss relief provisions relate to sole traders or partnerships. First, pre-trading expense of a revenue nature (incurred within three years before trading starts) may now be treated as a loss in the first year of assessment of a new business. Second, any losses made in the first year of assessment or in any of the next three years (after capital allowances and pre-trading expenditure), may be set off against your income for the three years of assessment prior to the year in which the losses were made. Again the relief must be claimed and the claim made within two years.

When you cease trading, and if you make a loss in your last complete year, you may set this loss against your business assessments for the three years prior to your ceasing to trade.

Retirement annuity contracts

Any sole trader will probably be concerned about his pension situation upon retirement. If you make payment to an authorised retirement annuity plan you may obtain full tax relief in respect of the premiums up to a permitted maximum¹ - that is, up to 60 per cent if your income tax rate is high enough. If you cannot afford to use all this relief in a particular year it can be carried forward to be used within the next six years. As the provisions relating to retirement annuity contracts can be particularly complicated professional advice should always be sought.

National Insurance

A sole trader must pay flat-rate class 2 National Insurance contributions (see Appendix 3). In addition he must pay earnings-related class 4 contributions which are collected by the Inland Revenue along with Schedule DI/II payments.

Since no additional benefits are offered for the class 4 contribution, this is very much a form of additional taxation. The benefits available through National Insurance are outlined later (pp. ____). It is very noticeable that the self-employed, unlike their employed counterparts, are not as well off. In particular they cannot claim unemployment benefit.

Class 4 National Insurance is paid as a percentage of Schedule DI/II income, after capital allowances and stock relief but with no deduction for personal allowances or pension contributions.

Since 6 April 1985 you can claim tax relief on half your class 4 contributions.

¹ The annual limit of contributions for retirement annuity plans since 1980-1 is 17 1/2 per cent of 'net relevant earnings'. (This means relevant earnings from the business less trading losses, capital allowances, etc.) The limit is increased for older taxpayers born before 1933.

Taxation of Partnerships

Income allocation

The determination of Schedule DI/II income for a partnership is exactly the same as for a sole trader - as are the provisions relating to stock relief, capital allowances, loss relief and the basis of assessment. The major difference arises on how the income is allocated to the partners and the determination of the subsequent liability to income tax. The liability to income tax, when determined, is placed upon the partners as a whole - this includes tax at the basic rate and at a higher rate. It is the responsibility of the 'precedent partner' (normally the senior partner) to make a joint return of partnership income each year.

Investment income is split between the partners in their profit-sharing ratios and they personally must pay the income tax due.

Schedule DI/II income must be allocated between the various partners in their profit-sharing ratios *in the tax year*. These proportions are not necessarily the same as the profit-sharing ratio when the profit was made. Any salaries paid to partners are not normally assessed under Schedule E but are included in the profits liable to Schedule DI/II tax. Interest paid to partners in respect of their capital is also treated as part of the Schedule DI/II profit and is not treated as an annual payment or taxed as investment income.

For example, suppose A and B are in partnership splitting profits equally after interest and salaries. They make up their accounts to 5 April each year.

After charging...						
	Net profit	Loan interest		Salaries		Gross profit
		A	B	A	B	
5 April 1986	£15,000	£700	£300	£4,000	£2,000	£22,000
5 April 1987	£18,000	£800	£400	£4,500	£2,500	£26,000

The total partnership assessment to tax is shown below:

1986-7 TAXABLE INCOME		22,000		
Less Interest	A	(800)	£800	
	B	(400)		£400
Less Salaries	A	(4,500)	£4,500	
	B	(2,500)		£2,500
Balance split equally		<u>£13,800</u>	<u>£6,900</u>	<u>£6,900</u>
1986-7 income allocation			<u>£12,200</u>	<u>£9,800</u>

Relief for losses

Partnership losses are apportioned between the partners in the same way as profits. Each partner can use his losses as he chooses, as outlined earlier (pp. ____).

Change of partners

If there is a change of partners it will normally be treated as a cessation of trade unless the partners elect to be taxed on the 'continuation basis'. This would mean that the rules relating to cessation of trade apply unless the election is made, in which case the partnership continues to be assessed on the preceding-year basis. Special rules apply to the 'new partnership' from its commencement which differ from the normal rules for the start of a business. The first few years are assessed on an actual basis and thereafter the preceding year basis applies, unless you elect for the fifth and sixth years also to be assessed on actual profits. On a change of partners the pattern of recent and projected

profits should be carefully considered as the opportunity to alter the basis of assessment to tax can be advantageous in that some high income years may simply 'drop out' of the assessment. The election for the continuing basis does not have to be made for two years from the date of change of partners. A married man should consider taking his wife into partnership in his business: first, because she can make use of the wife's earnings allowance (if she is not already working). Second, because (in the case of a couple with high earnings) it might reduce the liability to pay tax at higher rates if coupled with a wife's earnings election. And third, because of the rules outlined above on change of partnership.

Taxation of Companies

Corporation tax

Any limited company resident in the United Kingdom is liable to corporation tax on its profits. The rules for computing taxable profit for a *company* are the same as those relating to the various cases of Schedule D income or other Schedules if applicable. In particular, trading income is computed on exactly the same basis as Schedule DI/II, with capital allowances equally available (see pp. ____).

The rate of corporation tax, unlike income tax, is fixed by Parliament in the Finance Act for the *preceding* 'financial year' (1 April to 31 March). For periods from 1 April 1973, a small companies rate has applied for companies with taxable profits below a specified limit (fixed at the same time as the rate). Where a company's taxable profit is between this limit and that at which the full corporation tax rate is payable, marginal relief¹ is given on the tax which would be due at the full rate, based on the following formula:

$$F \times (\text{CT limit} - \text{'Profit'}) \times \frac{\text{'Income'}}{\text{'Profit'}}$$

Where:

F is a fraction set by Parliament.

CT limit is the lower limit at which the full rate is payable.

'Profit' is taxable profit including capital gains plus franked investment income.

'Income' is taxable profit excluding capital gains.

Appendix 1 shows the rates and limits currently applicable.

¹ For example, suppose the rates and limits were

Taxable profit below £100,000: 30 per cent

Taxable profit above £500,000: 40 per cent

Fraction for tapering relief: 1/40

(nb: Based on actual 1985 rates)

For a taxable income of £300,000 with no capital gains or franked investment income, tax payable would be:

$$£300,000 \times 40\% - 1/40(500,000 - 300,000) = £115,000$$

The effective marginal tax rate for the example shown above is 42.5 per cent, i.e. higher than the assumed full rate. In the past the effective marginal rate has been as high as 60 per cent. Such a high rate of marginal tax must act as a disincentive to growth for small companies.¹

However, remember that capital allowances are also available to companies. The *Inland Revenue Statistics* for 1986 reproduced in Table 9.4, show that 96 per cent of companies had taxable profits below £50,000 in 1983. The point to appreciate, once more, is that the profit reported in the financial accounts is not the same as the profit assessed to corporation tax. Capital allowances mean that taxable profit is usually considerably lower than reported profit.

Since the rate of corporation tax relates to 'financial years', if a company accounting year does not end on 31 March taxable profits are apportioned on a time basis between financial years. This is only important when the rate of corporation tax changes. For example, for the financial year 1986-7 the lower rate was 29 per cent and for 1987-8, 27 per cent. Thus for the accounting year ending 31 December 1987 one-quarter of income would be taxed at 29 and three-quarters at 27 per cent.

1 There are provisions which make it impossible to subdivide a company into smaller units each paying the lower rate of corporation tax.

Table 9.4 Net income chargeable to corporation tax, 1983

Chargeable Amount £	Number of assessments (thousands)	Cumulative (%)
0- 499	379.1	65
500- 599	23.1	69
1,000- 1,999	34.4	74
2,000- 2,999	20.3	78
3,000- 4,999	19.6	81
5,000- 9,999	35.0	87
10,000- 19,999	27.2	92
20,000- 29,999	12.6	94
30,000- 49,999	10.3	96
50,000- 99,999	10.4	97
100,000-199,999	6.1	98
200,000-499,999	4.0	99
500,000 and above	<u>4.9</u>	100
	<u>587.0</u>	

Source: Board of Revenue, *Inland Revenue Statistics*, 1986

Corporation tax is also paid on any capital gains. A fraction of any capital gains (see Appendix 1) is added to the income liable to taxation and always taxed at the higher rate, thus effectively making the rate 30 per cent, as for individuals. The original Finance Bill 1987 proposed that a company's capital gains will be taxed at the rate applying to its income, rather than 30 per cent chargeable gains would thus be added to income to find the total profit chargeable to tax and could mean that for example the marginal rate will apply rather than small companies' rate. These proposals were dropped in order to get the Finance Act 1987 on to the statute book before the general election. However, it is likely that they will be reintroduced at an early opportunity.

Corporation tax was first introduced in the United Kingdom in 1965. In 1973 the method of taxation was changed to what is called an 'imputation system'. This system is designed to be 'neutral' as far as dividend payments are concerned. This means that high dividend distribution companies should not be unnecessarily penalised. Under the imputation system, if a company pays dividends, they are paid net of tax at the basic rate of tax (see Appendix 1) to the shareholder, and the deduction is paid over to the Inland Revenue. This is called 'advance corporation tax' (ACT) and it may be deducted from the company's overall corporation tax bill, so that effectively a lower rate of tax is paid.

ACT is, in effect, just a dividend-withholding tax. If the shareholder does not pay tax at the standard rate the tax may be reclaimed by the shareholder, and if the shareholder pays tax at higher rates, then he will have to account personally to the Inland Revenue for that.

For example, let us suppose for simplicity that the basic rate of tax was 30 per cent and corporation tax was 40 per cent, and suppose a company earning taxable profits of £50,000 pays a net dividend of £14,000. This is equivalent to a gross dividend of

£20,000 on which income tax of £6,000 would be due ($£20,000 \times 30\%$). The corporation tax legislation would refer to an ACT rate of $3/7$ to be applied to the net dividend, but this is the same as 30 per cent on the gross dividend ($3/7 \times £14,000 = £6,000$). The company's total corporation tax bill would be £20,000 ($£50,000 \times 40\%$). However, the ACT would have to be paid over first and the balance of £14,000 ($£20,000 - £6,000$), which is called mainstream corporation tax (MCT) would be paid later. Notice the ACT to be offset against the total corporation tax bill is the amount on dividends actually *paid* in that year, not only on dividends declared. See Appendix 1 for current tax and ACT rates.

Basis of assessment: tax payments

Corporation tax is charged on the basis of the actual income assessable for each accounting period.

MCT is generally paid nine months after the accounting year end. Companies trading before 1 April 1965 have been able to retain their payment period at that date, but the Finance Act 1987 provides for this privilege to be phased out over three years.

ACT withheld must be paid to the Inland Revenue within 14 days of the following quarter days: 31 March, 30 June, 30 September and 31 December. In addition, if a company's accounting period does not end on one of these dates, the period of three months during which it ends is divided into two periods for which returns must be submitted.

Restrictions on ACT set-off

The amount of ACT which can be offset against a company's tax bill ('mainstream' corporation tax) is limited. The maximum amount is the ACT which would be paid if the company's taxable income was fully distributed. Thus, assuming the same simplified rates as in the previous example, if a company earns £50,000 it can only offset £50,000 x

30% = £15,000 of ACT. If it pays a dividend of £42,000 in that year (remember that payment could relate to the previous year's profits), then it must pay ACT of £42,000 x 3/7 = £18,000. The MCT to be paid will be (£50,000 x 40%) - £15,000 = £5,000. Hence the total tax paid (ACT + MCT) will be (£5,000 + £18,000) = £23,000. In other words the company has been unable to offset £3,000 of ACT and its effective tax rate is 46 per cent (£23,000/£50,000).

Recently the small companies rate of tax has been reduced and as it approaches the basic rate of tax the amount of unrelieved ACT will decline.

Unrelieved ACT may be carried *back* and set off against corporation tax payable for any accounting periods beginning in the six years (prior to 1 April 1984 only two years) preceding that in which the distribution was made. In most cases this will result in a tax repayment. Any ACT not set off in this way may be carried *forward* for set-off indefinitely.

Restrictions on ACT set-off arise primarily when taxable profits are low compared with reported profits. As long as reported profits are high shareholders may expect high levels of dividends, but if tax allowances are high, e.g. in the past capital allowances have included 100 per cent first year allowances, taxable profits are reduced and the ACT which can be set off is restricted. The problem also occurs when a company faces fluctuating profits and high dividends, relating to the previous year's good trading results, are actually paid in a year when profits are lower.

If a company pays a dividend it must pay ACT - even if taxable profits are zero. The dividend policy of a small company, where the manager is also probably the principal shareholder, requires careful planning so as to minimise the total tax liability the business faces, and to gain the maximum delay for those payments. Generally, dividends are not an attractive way of getting profits out of a company.

Relief for losses

Any adjusted loss arising for a company can be carried back for one year and set against taxable profits from the preceding year. Tax repayment may result. Any remaining losses may be carried forward indefinitely to be set off against future profits.

Expenditure incurred in the three years before trade commenced can be deducted from trading income in the year trade is first carried on. As with sole traders, when a company ceases to trade, it may set any loss in the last year against profits for the preceding three years.

Business expansion scheme

Introduced originally as the Business Start-Up Scheme for three years from 6 April 1981, the scheme, now known as the Business Expansion Scheme, was designed to encourage investment in small businesses by private individuals. Relief from income tax is obtained in respect of amounts subscribed for shares in a qualifying company. There are a number of detailed restrictions on what are qualifying trades, but generally included are manufacturing, retailing and wholesaling. The companies issuing the shares may be new companies or certain established unquoted trading companies.

The amount invested must be at least £500 and the limit for relief in any tax year is £40,000. Excluded from the scheme are employees, paid directors, and shareholders owning more than 30 per cent of the company. The shares on which relief is claimed must be held for five years, otherwise the relief will be clawed back.

Relief has been given in the tax year in which the shares are issued and there has been a tendency for investment to be concentrated at the end of the tax year - probably because of tax planning considerations. To alleviate this problem the Finance Act 1987 allows part of the relief on shares issued in the first 6 months of the tax year to be

carried back to the previous tax year. The amount which can be carried back is limited to £5,000 or half the relief on the shares issued (whichever is lower) and is subject to the overall annual relief limit.

Capital gains and losses on the sale of shares

If a businessman sells his shares in the company, he must pay capital gains tax of 30 per cent on the profits of the sale, even though the accumulated profits of the company will already have suffered corporation tax.

The Finance Act 1980 introduced an important relief for disposals of shares in small businesses. Individuals who were original subscribers for shares in an unquoted company can elect to relieve any loss on disposal of the shares against income tax. Previously, the loss had to be set against capital gains only. There are a number of stringent conditions which must be satisfied to obtain this relief but it is a considerable advantage for small businessmen.

Close and family companies

Potentially one of the major problems facing incorporated small businesses has been the special provisions enacted by Parliament in 1972 relating to what are termed 'close companies'. Close companies are broadly speaking those under the 'control' of 5 or fewer people and their 'associates'.¹ Hence the provisions apply to most small businesses. The majority of family businesses are also 'close'. The provisions are intended to inhibit the use of a company as a tax shield.

¹ 'Associates' include close family such as husband, wife, child, father, mother, brothers, sisters, etc.

The close company provisions are designed to inhibit the three most common ways of using a company to avoid paying tax. These possibilities are:

1. Disguising a payment to a shareholder as an *expense* of the business. This makes the payment both tax-deductible for the company and tax-free in the hands of the shareholder.
2. Disguising a payment to a shareholder as a *loan*. This would mean that the shareholder might not pay tax on what it is, in effect, a dividend.
3. *Not paying any dividend at all*, thus using the company as a tax shield for individuals in years when their tax rates might be very high.

The first possibility was dealt with by extending the meaning of distributions (dividends) for close companies. These are now held to include all 'benefits in kind' (such as living expenses and accommodation) provided for participants (shareholders or loan creditors) or their 'associates'. There are two important exceptions. If the recipient is a director or an employee, or if the benefit is the provision of a pension, then the benefit is not regarded as a distribution and is thus probably allowable against corporation tax, and ACT need not be accounted for on the benefit. Remember, however, that the benefit may still be taxable in the hands of the recipient under Schedule E income rules.

Prior to the Finance Act 1980 certain interest payments to directors were also treated as distributions. This is no longer the case.

The second possibility was dealt with by requiring close companies that make loans to participators or their 'associates' to pay a withholding tax on the loan at the current rate of ACT (see Appendix 1) - this is repaid if the debt is repaid.

However, if the debt is relinquished, the participator may also be required to pay higher rate tax on the gross amount.

Finally, the possibility of holding funds in a company which was being taxed at a lower rate than the shareholder was dealt with by some fairly extensive legislation allowing the Inland Revenue to apportion among shareholders the excess of 'relevant income' over the distributions, and tax them accordingly. These provisions have been considerably diluted: first, it was always fairly easy to convince the Inland Revenue that the funds were actually required for business purposes, including expansion or repayment of loans originally obtained for the purpose; second, the Finance Act 1980 narrowed the definition of 'relevant income' to include only investment income and 50 per cent of property income. Thus companies with only trading income can now retain as much money in the business as they please.

Retirement pensions

As a director of a company, a businessman can participate in what is termed an 'exempt approved company pension scheme' and there can be considerable advantages related to this. The company's contributions to such a scheme are tax-deductible for the company, and the directors and employees can obtain relief on their contributions of up to 15 per cent of their emoluments. The relief for regular personal contributions being at the highest tax rate paid by the businessman. The benefits of such a pension scheme can include:

1. Pension of up to two-thirds the final emoluments.
2. Part of the pension may be paid as a tax-free lump sum.
3. Widow's pension of up to four-ninths the final emoluments.
4. Life assurance of up to four times the final emoluments on death in service.

In the future, directors should be able to take out their own personal pensions and still obtain tax relief following the provisions of the Social Security Act 1986 (see pp. ____).

Taxation and Business

Should a business incorporate?

Probably the first question a small businessman asks his accountant is whether he should form a company. From a tax point of view there used to be a major advantage in not incorporating until a fairly high level of taxable income was earned. Since the small companies rate of corporation tax has been reduced to fall in line with the basic rate of income tax it is clear that there are tax advantages in forming a company. Furthermore the rate of corporation tax on higher profits is now considerably less than the higher rates of income tax (see Appendix 1).

The major disadvantage of incorporation is probably the fact that the company generally has to pay its taxes earlier than the unincorporated business - 9 months instead of up to 20 months after the accounting year end. This is equivalent to an interest-free loan for 11 months from the Inland Revenue.

Also the special rules which apply to the beginning and ending of a Schedule DI/II business, which means that the first year's profits can be doubly or trebly assessed, and on cessation one or two of the last year's profits can drop out of assessment, allow businessmen to organise cessation (for example, by changing a partnership), so as to ensure that high profit years drop out of assessment. This freedom does not exist for the company.

Further disadvantages of the company become apparent when the businessman tries to get his money out. The rules relating to close companies restrict the freedom of small incorporated businesses regarding expenses and loans to shareholders. If the businessman simply decides to leave the profits in the company, having suffered corporation tax, and, at some future date, to dispose of the company as a going concern, he faces capital gains tax of 30 per cent on any profit on the sale of those shares, despite the fact that those profits have already been taxed.

Normally, a director of a company will want to pay himself a salary. After all even director must eat. This also has its disadvantages. First, although the salary is a deductible expense for the company, the director must pay Schedule E (PAYE) tax on the salary and other taxable benefits such as a car (see Appendix 2). This must be paid when the salary is paid. Contrast this to the treatment of Schedule DI/II income. Second, PAYE must be paid whether the business is making a profit or not.

Probably the least attractive and most expensive way of getting money out of the company is to actually pay a dividend. The shareholders may have to pay higher-rate taxes on top of the basic rate withheld at source. Again, ACT must be paid over on designated quarter days, a problem the unincorporated business does not face. Luckily the Finance Act 1980 relaxed 'close company' rules regarding dividends, and the pressure to pay them no longer exists.

Also it is worth repeating that a company may still have to pay tax (income tax on the director's salary and ACT) even though it is making a loss. That loss can then only be set off against profits made by the company. For the sole trader he may set it against other *personal* income.

The situation regarding National Insurance must also be considered. As we saw, the sole trader pays a flat-rate class 2 contribution and a graduated class 4 contribution.

However, directors are personally liable to class 1 contributions, and furthermore the company must also pay the employer's contribution, which is considerably greater. All in all, the director (and his company) will pay more but he will obtain better benefits.

The sole trader is well advised to make use of retirement annuity contracts to improve his pension rights. However, even with these, unlike the director, he will not be able to claim unemployment benefit if his business collapses.

This chapter has steered clear of the very complex provisions of inheritance tax, formerly capital transfer tax (CTT). After 17 March 1986 lifetime transfers between individuals are only taxed if death occurs within seven years. There is specific relief against inheritance tax in respect to business property transferred. However, companies are generally a more flexible trading medium for minimising CTT. For example, partners will normally have the business valued as a whole based on underlying assets on any transfer, whereas it is possible to have small shareholdings valued on a dividend yield basis, thus reducing their value appreciably.

In conclusion, from a tax-minimisation point of view, incorporation is probably worthwhile now that corporation tax rates are low, but bear in mind other considerations covered elsewhere in the book.

Taxation and business decisions

Chapters and examine the financial criteria on which to base decisions. Incremental analysis is used to examine the effects on business profit or cash flow of a particular business decision. Frequently such decisions involve consideration of the tax consequences, and in these situations businesses need to consider the incremental or

marginal tax effect of the decision. This can be very difficult, since it involves 'guessing' the tax situation a business will face in the future, 'guessing' the future rates of tax, and then estimating the incremental effects of the decision on the tax situation. Clearly this involves a lot of crystal ball gazing. Yet large companies spend considerable sums on sophisticated tax planning, so they must think it worthwhile.

While sophisticated tax planning must remain an area for experts, all businesses need to have some basic ground-rules for evaluating the tax consequences of any decision.

Only the Chancellor of the Exchequer knows with any certainty what the rates of tax will be in any further period. Consequently businessmen can only base their decisions on current tax rates.

In assessing the incremental tax effect of any decision, marginal tax rates are of far more relevance than average tax rates. The marginal tax rate faced by a business indicates the proportion of any *extra* £1 of income that will go to the government. Sole traders and partnerships who pay tax face the marginal tax rates shown in Appendix 1 (headed "Tax rate"). As proposals yield greater additional profits, so the marginal rate of tax faced by the business will increase.

Companies with taxable profits below £100,000 face a marginal tax rate equal to the small companies rate for projects taking income up to £100,000. A company which undertakes a project raising its taxable profits into the range £100,000 - £500,000 faces the company's effective marginal rate (this is greater than higher rate corporation tax). Bear in mind that if the company faces ACT set-off restrictions, any extra £1 of income is available to set against ACT thus reducing the marginal tax rate to the difference

between the applicable corporation tax rate and ACT rate (see Appendix 1 for current rates).

Although these rates are no more than the broadest indicators of the potential complications which can affect the incremental tax charge a business may have to face, they do provide a simple framework to assess the tax effect of any business decision.

Tax-saving hints

To evade paying tax is completely illegal. However, an individual is free to minimise his tax bill. Be warned that tax planning is very complicated and professional advice is normally a sound investment. However, there are some simple points worth bearing in mind. The most important of these is never to do anything that saves tax at the expense of business benefits or which jeopardises the business in any way. Always remain as flexible as possible since tax rates and the tax system can, and do, change.

SOLE TRADERS AND PARTNERSHIPS

1. Obtain the maximum possible pension cover (remember retirement annuity contracts).
 2. Claim all possible business expenses. (Your car may be allowable for capital allowances and running costs.)
 3. Have an accounting year end of 30 April.
 4. Plan changes in partnerships to make the most of starting-up and cessation rules.
 5. Consider taking on your wife as a partner, if she can do some of the work - you can use up her personal allowances at the very least.
 6. Make the most of losses.
 7. Plan your capital purchases to gain the tax advantages as soon as possible.
- Generally make the expenditure towards the end of the accounting year.

COMPANIES

1. Set up a company pension scheme and join it.
2. Give yourself a company car¹ and other assets.
3. It may benefit you to give yourself an interest-free loan.
4. Plan your salary and dividends to minimise your tax liability.
5. Consider making your wife a director.
6. Plan your capital purchases and dividend payments to gain the tax advantage as soon as possible. Generally, make the expenditure towards the end of the accounting year.

¹ The tax liability raised on the individual on the provisions of a company car is laid out in Appendix 2.

Taxes Businesses Collect for the Government

VAT

Value-Added Tax (VAT) was introduced into the United Kingdom in 1973. All other EEC countries have VAT, though the rates are not harmonised. Since its introduction, VAT has been a constant irritant to businessmen. It now seems to take up more time than dealing with the Inland Revenue. Indeed the Customs and Excise, who administer the scheme, seem to have, and to exercise, considerably greater powers than the Inland Revenue.

VAT is payable whenever goods or services pass from one business or person to another. Even the import of goods suffer VAT, though when goods are exported no VAT is charged and any VAT paid may be reclaimed. The current rate of VAT is 15 per cent.

Generally a business must charge VAT on all goods or services it supplies (called 'outputs') and against this it may offset the VAT it has been charged on any goods or services (called 'inputs'). Unlike income or corporation tax, no distinction is made between capital and revenue items. Normally a business must pay over the difference between its 'outputs' and its 'inputs' to the Customs and Excise at the end of every three months. Should 'inputs' exceed 'outputs', a repayment of VAT may be claimed after only one month. A typical return to the Customs and Excise will show:

Total outputs during the period	£80,000	
VAT thereon		£12,000
Total inputs during the period	£40,000	
VAT thereon		<u>£ 6,000</u>
Balance payable to Customs and Excise		<u>£ 6,000</u>

All invoices supplying goods or services must show the VAT charged. Since each business gets a credit for the VAT it suffers, only the ultimate consumer actually bears the tax. A business merely acts as a collecting agent for the government.

All businesses with taxable turnover in excess of the limit shown in Appendix 1 must register with the Customs and Excise and are required to make these returns every three months. Any small business not registered must bear the 'input' VAT on all goods or services it uses, but does not charge VAT to its customers. Deregistration is allowed under certain circumstances (see Appendix 1).

The Finance Act 1987 provides for the introduction of regulations which will allow small business to account for VAT on the basis of cash received and paid rather than

relating it to invoice dates. This will require EEC approval and is not likely to be introduced before 10 October 1987. Small businesses will also be able to elect to make one VAT return annually (instead of every three months) although tax would have to be paid during the year in nine equal installments with a final balancing installment to accompany the annual return. This scheme is expected to start in mid-1988. Both schemes should help to relieve some of the VAT accounting burden currently falling on small businesses.

Because retailers cannot possibly account for each sale separately, special schemes exist or them.

Not all goods and services suffer VAT. Some goods are 'exempt', which means that no VAT need be charged on their supply. However, no credit is given for the 'inputs' to the business, and in this situation the business is forced to bear the costs of VAT. Typical 'exempt' goods and services include: land, education, banking, insurance, betting and gaming, health services, postal services, burial and cremation.

Some goods and services are called 'zero-rated'. This is probably the most beneficial status available because not only is no VAT chargeable on the supply of the good or service, but also any VAT charged on 'inputs' may be reclaimed. Typical 'zero-rated' goods and services, include: all exports, most foods, books and newspapers, construction of new buildings, transport, drugs and medicines, clothing for young children, large caravans and houseboats, and many fuels.

There are a number of special situations which need to be mentioned. VAT is chargeable on most second-hand goods, other than those where there are special provisions.¹ VAT on business entertainment, except relating to reasonable entertainment

of overseas customers, is not deductible (as in Schedule DI/II tax rules). Input VAT is not deductible on cars acquired for business use (again a special case in Schedule DI/II tax rules). These do not include vans or commercial vehicles, nor does it affect car dealers.

¹ Cars, motor-cycles, caravans, boats and outboard motors, original works of art, antiques over 100 years old, aircraft, electronic organs, have VAT charged only on the dealer's mark-up.

The provisions relating to VAT can be complex, and the amount of record-keeping required is certainly time-consuming. Strict provisions have been introduced to deter businesses from evading or delaying VAT payments. Penalties for overdue returns and payments may be imposed. For example the Finance Act 1985 introduced a 'default surcharge' of up to 30 per cent of the VAT involved which could be imposed from 10 October 1986. The Customs and excise issue over 20 special booklets which given details of the various provisions and how they relate to particular types of business. These can be obtained free of charge from any Customs and Excise VAT office.

Schedule E: Pay-As-You-Earn

Any business with employees, and this includes directors of companies, will have them taxed under Schedule E income tax collected under the 'Pay-As-You-Earn' system. The employer is responsible for administering the PAYE system: deducting the correct amount of tax from employees' salaries and paying it over to the Collector of Taxes on a monthly basis. Statutory sick pay and maternity pay are also now handled by employers instead of the DHSS. Amounts paid are taxed by the DHSS and can be reclaimed by the employer.

Employers may use their own records (including computerised records) to maintain particulars for each employee and calculate amounts due. The official Deductions Working Sheet (for P11(87)) may be used. These show:

- Personal details, e.g. National Insurance number, tax code, date of birth
- National Insurance contributions
- Maternity pay and sick pay
- Gross pay for the period
- Cumulative gross pay for the tax year to date
- Total 'free pay' pay to date (table A)
- Total taxable pay to date
- Total tax due to date (table B)
- Tax to be paid for the period

Total 'free pay' to date is found by reference to table A in the tax tables provided by the Inland Revenue. Total tax due to date is normally found by reference to table B in the tax tables (tables C and D relate to higher-rate taxpayers) and the tax due is found by subtracting the total tax due to date for the previous period from that due for the current period.

Each employee is given a code number by the Inland Revenue based upon the total allowances the taxpayer is due, calculated on his annual tax return. To convert your code number into allowances simply multiply by ten. For example, a code of 440 means the taxpayer has allowances of £4,400. A suffix H or L refers to the married or single status of the taxpayer.

At the end of each year the employer must complete a form (P35) showing total tax due and total tax collected for the year and return it to the Inland Revenue together with an end of the year return (P14) for each employee. The P14 is basically a summary of the information shown on the P11(87) or other record, including National Insurance number, date of birth, final tax code and totals of pay, National Insurance and tax deducted.

The employer should also issue a form (P60) to each employee, this is a copy (part of the set) of the P14.

When an employee leaves, the employer must issue him with another form (P45) and send another copy to the Inland Revenue. This form gives details contained on the taxpayer's deduction card which allows the new employer to prepare a new tax-deduction card in the normal way.

For directors and higher-paid employees (over £8,500) a further form (P11D) must be completed and sent to the Inland Revenue. This gives details of expenses and benefits in kind such as company cars or car expenses, entertainment, travelling, subsistence, company accommodation, subscriptions paid, medical expenses paid, educational assistance paid, beneficial loans¹ and many other categories. Against this is set the amounts repaid to the employer and the amounts from which tax has already been deducted under PAYE.

¹ A beneficial loan is one to a director or higher-paid employee or relative which bears interest at a rate lower than 12 per cent.

Generally the tax rules regarding expenses and benefits in kind are comparatively less favourable for P11D employees. Directors are taxed on premiums for sickness insurance

schemes, on the annual value of any company house, on the personal benefit from a company car (although the assessments are not excessive – see Appendix 2), and on 20 per cent of the market value when first used of any other assets (such as suits and furniture) given to the director (a point worth remembering).

The PAYE system is designed to ensure that at each point in the tax year the correct proportion of an individual's liability for the whole year has been paid. It is an ingenious system which operates with the minimum of involvement from the taxpayer. However, it is basically run by employers, and it is an expensive administrative operation – for all employers. The system works less smoothly when there are changes in taxpayers' personal allowances. If they go up during the year, the taxpayer must inform the Inland Revenue and it will refund the tax he has overpaid, up to his change of coding. If allowances go down, the taxpayer will generally be credited with the tax he should have paid up to the change of coding, and the deficiency collected in the subsequent tax year by reducing his allowances.

National Insurance

National Insurance contributions are paid by virtually all working people. The self-employed pay flat-rate class 2 contributions and earnings-related class 4 contributions. Employees must pay earnings-related class 1 contributions and their employers pay the employers' portion. The rates for 1982-3 are shown in Appendix 3.

At present, employers may be contracted in or out of the state earnings-related pension scheme (SERPS). Contracted out employees must belong to an approved pension scheme provided by the company.

The Social Security Act 1986 introduced the necessary legislation to enable individuals to leave their employer's pension scheme and take out personal pension from 1988. There are two basic aims behind these provisions. Firstly, it is now acknowledged that SERPS will cost more in the next century than originally anticipated and the country can afford. It is actually paid for out of the current working population's contributions rather than beneficiaries' past contributions. The percentage of salary that will be provided through SERPS for pensioners is therefore being reduced and the basis of calculating this contribution will be altered to further reduce its value. Secondly, it is hoped that individuals will be able to benefit from more flexible pension arrangements, for example, not losing future benefits if they change employment.

Any real pension scheme should have contributions related to the benefits obtained from the scheme. In the case of class 1, contracted-out, class 2 and class 4 contributions, this is not the case since the benefits from the scheme are not at all related to the payments individuals make. Only class 1, contracted-in to SERPS employees receive an element of earnings-related benefits. National Insurance is far more of an additional tax, on both employer and employee, than anything else, and it is a very expensive tax.

In return for the payments to National Insurance, contributors are eligible to such state benefits as retirement pensions, unemployment and sickness benefit and supplementary benefit. People who have not contributed to National Insurance are still eligible for supplementary benefit. The self-employed are not eligible for unemployment benefit, but they can claim supplementary benefit.

Unlike the PAYE scheme, National Insurance contributions are charged on a non-cumulative weekly basis, and therefore the weekly charge depends solely upon earnings in that week. It is not affected by earnings in earlier or later weeks. Therefore, it is

quite possible for a casual worker not to pay income tax, because his annual earnings are so low, but still to pay National Insurance contributions on a week-by-week basis.

Class 4 National Insurance contributions are paid, by the self-employed, along with their Schedule DI/II income tax to the Inland Revenue. Class 2 National Insurance contributions are paid over each month to the Department of Health and Social Security. Class 1 National Insurance contributions are paid over each month by employers, along with the PAYE deducted, to the Inland Revenue.

Appendix 1 Current Rates and Allowances

Tax year
commencing
6 April 1987

Sole traders and partnerships

Limited companies

Tax rates	Taxable income	Tax rate	Average rate*
	1st £17,900 @	27%	22.3%
	Next £2,500 @	40%	24.1%
	Next £5,000 @	45%	27.7%
	Next £7,900 @	50%	32.4%
	Next £7,900 @	55%	36.4%
	£41,201 upwards	60%	

* For a married couple with no allowances other than the £3,795 personal allowance. Calculated by taking total tax payable and dividing it by the income at top of the band plus £3,795. Thus for the range to £41,201 the calculation is:

$$\frac{16,378}{41,201 + 3,795} = 36.4 \text{ per cent}$$

Main tax Allowances

Personal reliefs

Single person	: £2,425
Married rate	: £3,795
Wife's earned income	: £2,425
Additional personal allowance for children	: £1,370*
Dependent relatives	: £ 100*
Housekeeper	: £ 100*
Blind person	: £ 540
Age allowance**	
65-79 Single	: £2,960
Married	: £4,675
80+ Single	: £3,070
Married	: £4,845

* Subject to certain conditions

** Reduced by £2 for every £3 of excess income over £9,800 down to personal relief level.

Corporation tax

Taxable profit less than £100,000 rate is:

Year ending 31 March 1987	: 29%
Year ending 31 March 1988	: 27%

Rate for taxable profit over £500,000
(Until 31 March 1988) : 35%

Marginal relief on profits between £100,000 and £500,000

Marginal relief fraction:

Year ending 31 March 1987	: 3/200
Year ending 31 March 1988	: 1/50

Effective marginal rate:

Year ending 31 March 1987	: 36 1/2%
Year ending 31 March 1988	: 37%

Capital gains tax - taxable fraction:

Year ending 31 March 1987	: 6/7
Year ending 31 March 1988	: None specified*

* Presumably this relates to intention to tax company capital gains at corporation tax rates.

Advance corporation tax (ACT) rates

Tax year to 5 April 1987	: 29/71 x dividend paid
Tax year to 5 April 1988	: 27/73 x dividend paid

Appendix 1 Current Rates and Allowances (continued)

Tax Year commencing 6 April 1987	Sole traders and partnership	Limited companies
Capital allowances	Plant and machinery Cars Industrial buildings Enterprise zones: Industrial and commercial buildings, shops, offices and hotels Hotels Agricultural buildings Patent rights and 'know how'	: 25% on reducing balance : 25% on reducing balance (max. £2,000) : 4% on original cost : 100% allowance : 4% on original cost : 4% on original cost : 25% on reducing balance
Capital Gains Tax	Capital gains tax is levied on gains upon the disposal of chargeable assets. Chargeable assets include all forms of property, stocks and shares, land and buildings, goodwill, certain debts, options and currency other than sterling. Gains in excess of £6,600 @ 30%	Effective capital gains tax rate has been 30% but is likely to change to corporation tax rate in 1987. Trading losses can be set off against capital gains of the same or previous period. Assets held over 12 months have their cost increased by reference to the increase in the retail prices index between acquisition (or March 1982 if later) and disposal. Indexation may create or increase a capital loss. Losses may be carried forward to set against future capital gains. Subject to certain conditions, gains (up to £100,000 for those aged 60 and over) on the disposal of a business or shares in a family trading business are exempt from capital gains tax. Losses on the disposal of shares in unquoted companies may be set against income tax, subject to conditions.
Value Added Tax	The annual registration limit for VAT is £21,300 from 18 March 1987 (quarterly limit £7,250). Deregistration is allowed if future supplies will not exceed £20,300 (this limit operates from 1 June 1987). Standard rate of VAT is 15%, all other supplies are either zero rated or exempt.	

Appendix 2 Car and Fuel Benefit Scales

Car benefit	Cars under 4 years old		Cars over 4 years old	
	1987/88 £	1988/89 £	1987/88 £	1988/89 £
Original market value up to £19,250 with cylinder capacity:				
1400cc or less	525	580	350	380
1401cc - 2000cc	700	770	470	520
over 2000cc	1,100	1,210	725	800
original market value				
£19,250 - £29,000	1,450	1,595	970	1,070
over £29,000	2,300	2,530	1,530	1,658
Fuel benefit 1987/88 and 1988/89				
£				
Cylinder capacity				
1400cc or less		480		
1401cc - 2000cc		600		
over 2000cc		900		

Appendix 3 National Insurance Contributions 1987/88

Total weekly earnings	Contracted in		Contracted out	
	Employee	Employer	Employee	Employer

CLASS 1

Up to £38.99	NIL	NIL	NIL	NIL
£39.00-£64.99	5%	5%*	2.85% +	0.90% +
£65.00-£99.99	7%	7%*	4.85% +	2.90% +
£100.00-£149.00	9%	9%*	6.85% +	4.90% +
£150-£295	9%	10.45%*	6.85% +	6.35% +
over £295	(Note 1)	10.45%*	(Note 2)	(Note 3)

* on all earnings.

+ on earnings over £39.00. The first £39.00 is charged at the contracted in rate appropriate to the level of earnings.

Note 1: Employee's maximum contribution is 9% of £295 (ie £26.55).

Note 2: Employee's maximum contribution is 9% on first £39.00 plus 6.85% on earnings between £39.00 and £295 (ie £21.04).

Note 3: 10.45% on first £39.00 plus 6.35% on earnings between £39.00 and £295 plus 10.45% on excess over £295.

CLASS 2 (self-employed)
(not payable by male over 65 or female over 60)

£3.85 per week on
earnings above £2.125 per
annum

CLASS 3 (voluntary contributions)
(the benefit of which is mainly
entitlement to basic retirement
pension)

£3.75 per week

CLASS 4 (self-employed)
(not payable by male over 65 or female over 60)

6.3% on profits
assessable to tax between
£4,590 and £15,340 per
annum (maximum
£677.25)