



Tax treatment of business expenses

For small business owners, the classification of business expenses as allowable or non-allowable can be a minefield. This article sets out to shed some light on the rules.

Allowable expenses are those costs that you incur for the sole purpose of earning business profits, and may be deducted from your turnover for the purposes of reducing the tax liability of the business; if not totally then at least in part. They include, for example:

- ◆ Goods purchased for resale
- ◆ Wages, rent, rates, repairs, lighting and heating
- ◆ Running costs of vehicles or machinery used in the business
- ◆ Professional fees, interest paid on monies borrowed to finance business expenditure or items, and leasing charges on items used for the business

Non-allowable expenses include costs that you incur for a non-business purpose, such as, for example:

- ◆ Your own personal expenses or drawings
- ◆ Capital costs
- ◆ Costs which are recoverable under insurance

Wholly and exclusively

For expenses paid by the company to be allowable, the basic rule is that they must be incurred wholly and exclusively for purposes of trade. Normally, if an expense results in

“benefit in kind” for an employee, then it is deductible for the company.

If the business is a sole trader or partnership, any private use by the owners restricts the amount of the expense that is allowable for tax purposes.

Expenses paid by the employee are allowable only if they are incurred wholly, exclusively and necessarily in the performance of the duties of the office or employment.

Benefits in kind

Where a company incurs costs or provides assets for the private use of directors or employees, these normally result in a benefit in kind charge, that is, additional income tax payable by the employee and Class 1A National Insurance contributions, currently 12.8%, for the employer.

If a company pays an employee’s personal liability, such as a private holiday for him and his family, this should be treated as salary, incurring tax and National Insurance charges accordingly.

Duality of purpose

HM Customs & Revenue (HMRC) does not regard any expenditure that has a dual purpose element to be allowable for taxation. For

example, a suit or dress purchased to wear at work has a dual purpose in that you need to wear clothing anyway, so tax relief is not available on the expense.

In the famous case of a barrister who claimed the costs of buying and keeping clean the black clothing worn in court, the Revenue successfully argued that although she bought the clothes solely for work, she had to wear them to remain decent. She lost her case.

Capital items and depreciation

A distinction should be made between ‘revenue’ and ‘capital’ expenditure; this article addresses expenses that fall under the ‘revenue’ banner.

Generally, capital items are those items that will have enduring benefit to the company, such as computers, motor vehicles and office furniture. If they are connected to the trade, it may be possible to claim capital allowances over a period of time, based on percentages specified by HMRC, but you may not claim their cost as an allowable expense.

Depreciation is not usually tax deductible either, except for pure finance leases, not commonly used by small businesses.

Legal and professional fees

Fees for preparing your company accounts are deductible as they relate to your trade. Legal fees incurred on taking on a new lease are not deductible as they relate to capital.

If a company pays the cost of an employee's personal tax return, this is classified as a benefit in kind.

The costs of recovering debts, defending business rights, preparing service agreements and appealing against rates on business premises are allowable. Expenses (including stamp duty) for acquiring land, buildings or leases are not allowable.

Subscriptions

Subscriptions to professional and trade associations on HMRC's approved list are allowable, as are trade magazines.

Debts, taxes, penalties and fines

Specific bad debts written off are allowable, whereas a general reserve for bad or doubtful debts is not. If the company is not entitled to recover VAT, the VAT inclusive expense is allowable.

Interest and penalties relating to income tax, PAYE, NIC and VAT are not deductible, nor are fines and other penalties for breaking the law unless a benefit in kind is assessable on an employee. Corporation tax interest under self assessment is deductible and taxable in the company's hands.

Interest

Interest charges incurred to finance the business, but not owners' drawings, will normally be allowable. In certain circumstances, interest on funds borrowed in your personal capacity and introduced into the business will be allowable, provided that it does not involve overdraft or credit card interest, and that you can prove that the money was borrowed for the business.

Entertainment and gifts

Business entertainment is not an allowable expense, nor is the cost of gifts to customers, unless they are £50 or less in value and carry a conspicuous advertisement for the business. Gifts of food, drink, tobacco, vouchers and tokens exchangeable for goods are specifically excluded.

Staff entertainment, such as a Christmas dinner or summer party, is an allowable expense for the company and will not be classified as a benefit in kind for employee provided that the cost per head is less than £150 per annum and the event is open to all staff. Note: This concession is not available to Schedule D (self-employed) businesses.

Travelling and subsistence

An employer may reimburse an employee for travel, accommodation and subsistence costs incurred wholly, exclusively and necessarily for the purpose of the duties of the employment. Travel to a temporary workplace is allowable until the expectation arises that the assignment will last for longer than 24 months, after which it is classified as ordinary commuting and therefore not allowable.

Home to office travel is defined as ordinary commuting, and it is therefore important to establish where the business is being operated from. If you genuinely operate from home, you can normally claim travelling expenses when visiting clients.

Employees who use their own cars for business purposes may claim 40p per mile for the first 10,000 business miles and 25p thereafter in each tax year. Sole traders and partners can alternatively claim a percentage of the actual costs incurred, such as petrol, capital allowances, interest on a loan to purchase a car, insurance, oil, maintenance and road fund licence. The percentage must be justifiable, and therefore it is best to keep a detailed mileage log of actual business and total mileage.

The London congestion charge is allowable provided that it is incurred exclusively for business purposes.

Subsistence up to reasonable levels while away on business is allowed: this will usually cover the cost of a meal with reasonable alcoholic and non-alcoholic drinks; and tea, coffee, and soft drinks between meals.

The cost of overnight accommodation is allowed if solely for business purposes, and the employee may also be reimbursed for incidental costs such as laundry, newspaper and telephone calls home, up to £5 a night in the UK or £10 a night outside the UK.

Subsistence not related to an overnight stay can present problems in terms of the 'duality of purpose' rules: you are expected to "eat to live, not eat to work". There are arguments for claiming such meals, but this is definitely a grey area.

Use of home for work

If you work from home, you may theoretically claim a proportion attributable to business use of lighting, heating, cleaning and insurance, as well as a proportion of rent, business rates, council tax and (in Northern Ireland) domestic rates.

You should be extremely wary of this though, as it could create capital gains problems for you when you sell your home. It may be better to consider claiming a nominal amount, such as £104 a year, instead.

Wages and salaries

You should issue a P60 at the end of the year to support the amounts paid, and ensure that the level of remuneration is justified for the work done, as HMRC may disallow remuneration paid to employees that it considers excessive.

Payments to a spouse should be made to an account in his or her sole name, not to a joint account. Drawings by Schedule D taxpayers (sole traders and partners) are not allowable for tax purposes.

Training

Where the purpose of training is to provide a business owner with new skills, the cost is treated as capital and is not deductible for income tax. If the purpose is to update existing skills, then the expense is allowable.

Where the IR35 rules apply, training expenses may be included within the five per cent allowance for general expenses but not claimed separately in their own right.

Telephone and internet

The cost of a mobile phone is allowable, and if invoiced to the company, there is no benefit in kind, even if there is an element of private use. If invoiced to the employee, then the benefit in kind is assessed on the portion attributable to private use. It is helpful if you have itemised bills to prove the split between business and private use.

The cost of broadband and other internet services is allowable, and if invoiced to the company then incidental use by the employee does not rate as a benefit in kind. If the service is invoiced to the employee and reclaimed, the element of private use by the employee may be treated as earnings.

Private consumption

The sales price of goods funded by the business but taken for private consumption by a sole trader or partner must be taxed as income in your accounts.

Working overseas

Medical expenses incurred whilst working abroad as part of your employment duties can be paid by the company without being rated as a benefit in kind. The same applies to business travel costs involved in sending the employee abroad to do their job.

Insurance

Business insurances are allowable, as are life insurance, personal accident insurance, permanent health insurance and private medical insurance for employees. A sole trader's or partner's own life, accident, permanent health and private medical insurance expenses are rarely allowable.

Important notes

You should ensure that all claims are supported by receipts to justify that the cost was actually incurred.

The rules for what counts as allowable are more generous for self-employed people (Schedule D taxpayers) than for employees.

The VAT treatment of the expenses mentioned here may differ from the tax treatment, and different rules apply to any contracts covered by IR35.

Expenditure is normally allowable within the company's accounting period in which it was incurred. Special rules, however, can mean that revenue expenditure incurred up to seven years before commencing trade may be treated as incurred on the first day of trading.



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