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Entertaining Expenses - What are the Tax Rules?

Entertaining expenses are a special case and are not subject to the normal rules governing deductibility of business expenses. The rules are harsh and operate to deny a deduction for most entertaining expenses when computing the taxable profits of a business. The disallowance applies regardless of the purpose of the entertaining expenditure and irrespective of whether the entertaining was wholly and exclusively for business purposes.

The prohibition was introduced in the 1960s to curb increasingly lavish business entertainment in what was perceived to be an abuse of the rules on the deductibility of expenses.

What counts as business entertainment?

As business entertainment is not deductible for tax purposes, it is necessary to add back any business entertainment expenses included in the accounts when preparing the tax computation.

To ensure the correct amount is added back it is important to understand what counts as business entertaining.

The legislative definition is not particularly helpful, in that it defines entertainment as including hospitality of any kind, but provides no further clarification as to what is entertainment or what is hospitality.

However, case law has provided further insight as to what constitutes business entertainment and guidance as to the meaning can be found in HMRC's Business Income Manual at BIM45000 and following (www.hmrc.gov.uk/manuals/bimmanual/BIM45000.htm).The concept of a host/guest relationship is central to the meaning of business entertainment – the host provides the entertainment and the guest receives it.

It should also be noted that the disallowance extends to any incidental costs of providing the business entertainment, such as the cost of taxis to the venue.Where business entertainment is provided there will normally be an element of bounty. However, while business entertainment will often be provided free of charge to the recipient, this is not a necessary condition and subsidised entertainment will also count as business entertainment.

For example, a business might spend £2,000 providing a social event for customers, who are charged £15 to attend and 50 people attend, such that the net cost of £1,250 is regarded as business hospitality and is not deductible.

However, there is no disallowance if there is a contractual obligation to provide hospitality, as would be the case where food, drink and hospitality are provided as part of a package of services for which payment is made. Similarly, there is no disallowance where the hospitality is provided on a quid pro quo arrangement.

Business entertaining and hospitality may take various forms, ranging from the provision of drinks and snacks to more lavish meals and will include events such as a day at the races or at a sporting fixture. Care must be taken with promotional events designed to publicise the promoter's products. While the promotional event is not business entertainment, the costs of any food or drink or other hospitality provided as part of the event would not be allowable.

Exceptions – allowable entertaining

Although there is a general rule that business entertaining expenses are not deductible in computing taxable profits, there are some exceptions to this general rule and consequently some circumstances in which entertainment expenditure is deductible.

The major exception is staff entertainment, which is allowable as long as it is incurred wholly, exclusively and necessarily for the purposes of the trade. Further, the entertainment of staff must not be merely incidental to the provision of entertainment for customers. For example, while a staff lunch would be staff entertaining and would be allowable, by contrast, if an employee takes a customer out for lunch, this would be classified as business entertainment and would be disallowed.

There is a further sting in the tail. Although staff entertainment is deductible in computing the taxable profits on the business, unless the entertainment is of a type covered by a particular exemption, such as that for Christmas parties and similar functions, the employee will suffer a benefit in kind charge on the provision of the entertainment.

Practical Tip :

To avoid falling foul of the rules on business entertainment, make sure adequate records are kept and that you don't forget to add it back when doing the tax computation.

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Sharing the Family Home: an IHT Saving

IHT: the basics

Inheritance tax (IHT) is levied on lifetime gifts (at 20%) and on death (at 40%).

Each individual is entitled to a "nil rate band" currently worth £325,000. What this means is that, for example, on death IHT at 40% is payable on the individual's estate (i.e. his assets less liabilities) in excess of £325,000. Where one spouse leaves their whole estate to the other surviving spouse (an exempt inter-spouse transfer) no IHT is payable on the first death and on the death of the surviving spouse only the amount of the survivor's estate in excess of £650,000 (i.e. two nil rate bands) is subject to IHT at 40%.

If therefore a couple jointly own their home worth say £750,000 (assume no mortgage outstanding) and the first spouse to die leaves their interest to the other spouse then on the death of the latter IHT of 40% of [£750,000 - £650,000] i.e. £40,000 is due.

Gifting the home

To avoid such an IHT charge many couples appear to believe that they can give their home away (typically to one or more of their children) yet continue living in it. It is true that the lifetime gift from parent to child qualifies as a PET (i.e. a potentially exempt transfer) and so long as the donor (i.e. the parent) survives at least 7 years no IHT arises on the gift. However, on death of the parent, despite no longer owning the home it continues to be treated as part of the parent's estate and IHT is charged on it; this is because the lifetime gift is classified as a "gift with reservation".

In essence, although the home has been given to (say) the children the parents continue to occupy it and are regarded in a sense as still owning it for IHT purposes.

Sharing

Where parents wish to continue to live in their home but reduce IHT on death one under-used option is for a share of the home to be given (say) to one of their children (or possibly more than one) following which both parents and child(ren) occupy the property together.

The gifted interest in the home qualifies as a PET and thus in principle falls outside of the donor's estate so long as the donor survives for seven years. Furthermore, even though the parents continue to occupy the home the gift is not treated as a gift with reservation in which case the gifted share does not form part of the parents' estate on death (and hence no IHT is charged on that share).

In practice a gift of 100% of the home is not acceptable to HMRC but a gift of no more than 50% appears acceptable; thus, parents would retain 50% and child(ren) would also own 50%.

It is important that the parents do not receive any benefit associated with the gift from the children who own the other 50% otherwise the gift with reservation provisions apply (and no IHT saving is achieved).

To prevent the parents from receiving any benefit from the children the running expenses of the property (ie heating, lighting, etc.) should be paid by both donor and donee reflecting their respective usage (not reflecting their respective ownership percentages). If, for example, 20% was gifted to one of the children (the parents retaining 80%) the expenses should be split one third each (not 40/40/20%).

There is, however, nothing to prevent the parents continuing to pay all the running expenses of the property and may be preferable (see below).

Outright sale compared

Another option often considered is an outright sale of the property for market value to the children followed by rent-free occupation by the parents (but not the children).

The main disadvantage of this option is that on a future sale of the property a capital gains tax (CGT) charge will arise as the children (who own the property) do not live in it; whereas the gift followed by joint occupation option discussed above precipitates no CGT on sale.

Conclusion

Although the co-ownership option is perhaps not suitable for some family situations, as children are finding it increasingly difficult to fund their own property purchase, and parents find it more difficult to fund household running costs, perhaps sharing offers an increasingly realistic option.

Practical Tip :

It may be sensible for the parents to continue to discharge all the running costs as this will also dissipate their estate for IHT purposes on death whilst at the same time benefitting the children.

How to Pay off Your Main Residence Mortgage And Claim Tax Relief!

The importance of paragraph 45700

Every landlord should know paragraph 45700 of HMRC'sBusiness Income Manual
(www.hmrc.gov.uk/manuals/bimmanual/BIM45700.htm)
almost by heart, because it describes a very powerful tax relief that, properly used, can greatly increase your disposable income by transferring your mortgage on your home (for which you cannot claim a tax deduction for interest paid) to mortgages on your buy to let portfolio, the interest on which is deductible against your rental income. This technique only works for individual landlords, not for limited companies, so it is an important point to consider when deciding whether to use a company for your letting business or not.

Understanding basic accounting principles

In order to understand how this works, we need to consider basic accounting principles. When you, as an individual, begin to let a property for the first time, you have "introduced capital" to your new business of property letting. The amount of capital introduced is the market value of the property at the time you begin to let it, minus any loans secured on that property.

If we take a simple case of inheriting a property and deciding to let it (so there are no loans involved at this stage), then if that property has a market value of £200,000 on the day you begin to let it, you have introduced capital of £200,000 to your new property business.

A common misconception

You are entitled to withdraw this capital from the business at any time without any tax consequences, and if the business has to borrow money to finance this withdrawal, then the cost of the interest on that loan is an allowable expense of the business. It does not matter what the money withdrawn is used for, because the purpose of the loan was to finance your withdrawal of capital you had previously introduced to the business.

If, therefore, you have a mortgage on your home of £150,000, and you raise a loan secured on the letting property of that amount and use it to pay off the mortgage on your home, you have just transformed the home mortgage into a business loan, and you can claim the interest on that loan against the letting income from the property.

In cases where you need to use a mortgage to buy a letting property, then the capital you introduced will have been the difference between the market value of the property when you first let it, and the amount of the loan used to buy it.

Once the property has increased in value to the point where you could refinance and increase the loan to the market value when the property was first let, the surplus cash can be taken out of the business and used for any purpose you like – including paying off all or some of your home mortgage – with the interest still fully deductible against the income from the property business. If you have more than one letting property, all such properties (within the UK) are treated as one business, so the interest is deducted from the total of all the rents received.

Avoiding the trap

If you have followed the explanation of the accounting treatment of the introduction of properties to the letting business, you will avoid the trap that catches some people – the limit on the loan that will qualify for tax relief on the interest is the market value of each property at the time it was first let. If you borrow more against a property than this amount, the tax relief on the loan will be restricted to the amount representing the loan up to that historic market value.

Of course in the real world things are more complicated than this, and in particular there may be repayment penalties on your home mortgage, and in general, interest rates on home mortgages tend to be lower than that on buy to let mortgages. It is nevertheless worth doing the sums in any case where you are a buy to let landlord, and you also have a mortgage on your home.

Practical Tip :

In some cases, this can be taken another stage further. If you decide to move home, bear in mind that if instead of selling your old home you let it, you can raise a loan secured on the old home and this loan will qualify for tax relief because the old property is now part of the letting business.

Personal Tax

Dispensations for Employers

You can save a considerable amount of time and money by applying to HMRC for a dispensation for certain business expenses reimbursed to employees by the company.

A dispensation frees the employer from having to report certain expenses to HMRC and can be granted for those expenses in respect of which a corresponding tax deduction can be claimed.

A dispensation also removes the need for the employee to claim the tax deduction, saving work all round.

This applies to any size of company, from a one-person company to large multi-nationals, although obviously the more employees you have, the more time you will save in not having to complete the sections of the P11D that are no longer relevant once a dispensation has been granted.

Case Study

John is fed up with the time-consuming job of completing P11Ds for his employees when all he does is reimburse business expenses.

He applies for and is granted a dispensation for the business expenses of his employees.

This means that he no longer has to complete P11Ds for the employees as no benefits are reportable. Therefore it leaves him with more time to get on with running the business.

Property Tax

Jointly Owned Property

By default, rental profit from property jointly owned by spouses/civil partners is taxed 50:50 irrespective of the underlying respective proportion of actual ownership.

However, if it would be more income tax efficient for the split of profit to be different, the underlying ownership also needs to be changed to the same percentage. Plus, most importantly, a form 17 *'Declaration of beneficial interest in joint property and income'* must be filed with HMRC within 60 days of the change of ownership (this restriction is strictly applied).

The declaration comes into effect from the date of signature and remains in place until either the date on which the interests in the property or income change, or the owners stop living together as a married couple/civil partners.

Case Study:

Deduct Allowable Travel Expenses

Andrew and Anne are married and jointly own a rented property. Andrew is a 50% 'additional' rate taxpayer and Anne is a 20% 'basic' rate taxpayer. Their accountant has calculated that it would be more beneficial for the profit to be split 80:20 to ensure that the least income tax is paid.

The ownership is therefore changed to 80:20 and the declaration form 17 signed, but unfortunately it was not submitted within the 60-days' time limit.

The income tax split therefore remains at 50:50 but legally the underlying ownership has changed to 80:20.

To take advantage of the income tax benefit a new declaration form 17 must be signed and resubmitted within a fresh 60-day time limit.

Business Tax

Choose the Method of Tax Relief for Early Year Losses

Losses made in the opening years of a business can be carried back against the total income of the preceding three tax years.

However, this is not the only option for relieving early year losses. The loss can also be set against other income for the year in which the loss was incurred or the previous tax year or carried forward against future trading profits.

The basic aim of loss relief planning is to obtain relief at the highest marginal rate of tax and earlier rather than later. The decision as to which route to take to relieve the loss will depend on the level of other income, expected future profits, income of previous years and the rates of tax in the years concerned.

Case Study:

Jane starts her business on 1 January 2012 and makes a loss of £10,000 for 2012/13.

She has other income of £30,000 in 2012/13 and had income of £8,000 in 2011/12. In 2009/10 and 2010/11 she had income of £5,000 and £6,000 respectively.

She secured a major contract in May 2012 and as a result expects her profits to be £100,000 in 2013/14.

Jane can relieve the loss against her other income of 2012/13 of £30,000, but she will only receive relief at the basic rate of 20%. However, if she carries the loss forward and sets it against the profits of £100,000 she will receive relief at 40%. By choosing this option, the loss saves her tax of £4,000, rather than £2,000 if it is set against other income of 2012/13.

It is not worthwhile carrying the loss back to 2009/10 as her income for that year is offset by her personal allowances.