

Corporation Tax Deductibility of Year End Bonuses

The aim of this bulletin is to highlight one particular area to which companies may have given relatively little thought in the past, but where significantly more challenges are likely to arise in future. The issue in question is the inclusion of provisions for directors' or employees' bonuses in year end accounts in respect of payments made thereafter and the consequent corporation tax deduction claim.

Background and the "Nine Month" Rule

You should be familiar with the rule which requires accrued salary or bonuses to be paid via PAYE within nine months of the accounting period end in order to be eligible for a corporation tax deduction in the year in which a provision is made rather than the year of actual payment.

Validity of Provisions in Year End Accounts

For accounting periods beginning on or before 31 December 2004 the position was fairly straightforward. However, subsequent changes in the legislation now require that in order for a provision to be recognised in the accounts of the company, the following criteria must be met.

- A present obligation (legal or constructive) must exist (on the balance sheet date) as a result of a past event.
- It must be probable that a transfer of economic benefits will be required to settle the obligation.
- It must be possible to form a reliable estimate of the amount of the obligation.

For the purposes of assessing the acceptability of accrued salary or bonus provisions, the second and third bullet points would not appear to pose any particular problem in themselves. If it is established that there is an obligation in respect of accrued salary or bonus then a transfer of economic benefits (i.e. payment) will be required and there should be no problem in producing a reliable estimate of the amount of the obligation. It is the first condition which is likely to be more difficult. It is arguable that in circumstances where bonuses have only been decided upon post year end, no legal obligation would have existed at the balance sheet date. The advice which follows is therefore concerned with, ideally, creating a legal obligation as at that date or justifying a provision by reference to a constructive obligation.

Recommendations

- Best Practice in terms of demonstrating a present obligation at the balance sheet date would be to prepare a formal Board Minute prior to the year end documenting the directors' intention to pay a bonus or bonuses and outlining the specific amounts involved.
- If the specific amounts are not known, the directors may prefer to establish a structure or formula for the amounts involved according to which they can be calculated once the draft accounts have been prepared and are available for review, for example a percentage of after-tax profit above a certain level. Minuting this decision prior to the balance sheet date would also give rise to the necessary obligation at the balance sheet date.
- Where a specific decision has not been made, a history of bonuses being paid potentially based on the trading performance of the business or individual performance may be sufficient to demonstrate a constructive obligation especially if the directors were to determine, again before the balance sheet date, a policy of continuing the previously adopted bonus policy.
- In the absence of a history of bonus payments, there may be evidence to suggest that a constructive obligation has nevertheless arisen and the director or employee in question has been given a valid expectation they will receive a bonus, either as a result of the performance of the business as a whole or their individual performance. Ideally such an expectation should be documented before the balance sheet date.

Whilst the concept of a constructive obligation is one which is understood by HM Revenue & Customs, it should be appreciated that reliance upon a constructive obligation may give rise to issues of greater subjectivity and a Tax Inspector is likely to require written evidence of the constructive obligation and its existence at the balance sheet date before accepting that corporation tax relief is due. It is therefore suggested that if bonuses are contemplated for a particular accounting period which are to be paid at a later date some decision on this policy and ideally on the specifics of the policy, should be made and documented prior to the balance sheet date. This should ensure any

provision for such bonuses made in the company's accounts is in compliance with the relevant accounting standards and thereby represents an allowable provision for corporation tax purposes. These considerations will be particularly relevant in a company's first accounts as there will be no history of bonuses in previous years to support any contentions that the directors/employees have a valid expectation of the receipt of a bonus. The same position arises for an established company if, in previous years, bonuses have not been paid or if paid, have been at a much lower level.

Dividends

In the interest of completeness it should be noted that the issues highlighted are unlikely to cause any difficulties where, following a year end, the directors of a company decide to pay a dividend. Whilst the current accounting standard governing events after the balance sheet date (FRS 21) prohibits the inclusion of proposed dividends in the accounts of the company, this has no bearing on the corporation tax position as no tax relief is available to the company in respect of a dividend payment and under such circumstances the dividend will be shown in the year in which it is paid. However it is important to ensure that the appropriate Companies Act procedures are followed to ensure there can be no argument from H M Revenue & Customs that purported dividends are in fact disguised remuneration liable to PAYE and NI.

If you feel this might be of relevance to your particular circumstances, either now or in the future, it would be prudent to plan any staff or directors' bonuses well before the year end.