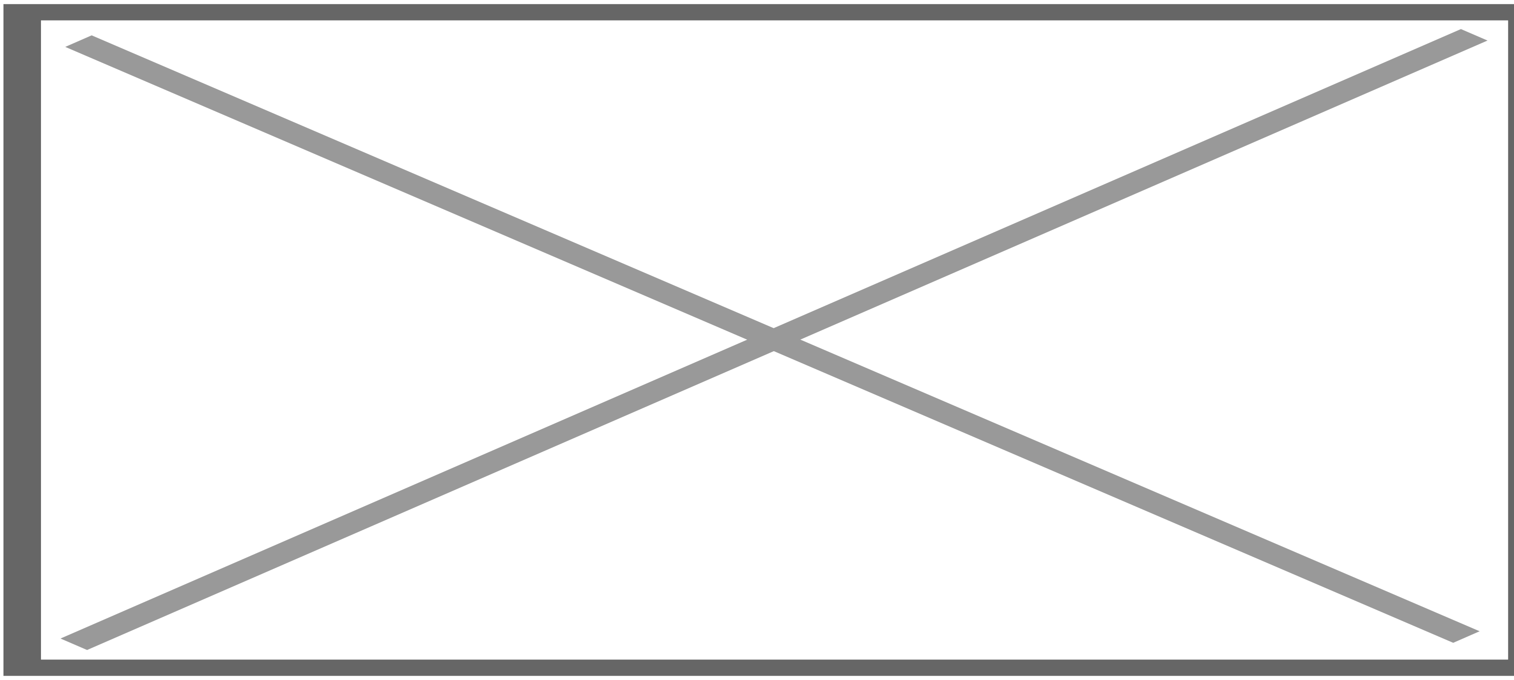
Mitigating the worst impacts of an inflationary environment

Large Corporate OMB



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High and increasing inflation will have unexpected consequences. How can businesses mitigate its impact on corporate profits and tax risk?

Tax revenue in the UK is rising to sustained levels not seen since the 1950s (see bit.ly/3MPhqMv). High and increasing inflation will enhance the tax take and have unexpected consequences on both after tax returns and the corporate approach to tax risk. Much has been made of the impact on individuals, but the impact on companies has had little attention. They need to brace themselves for an assault on their post-tax profitability and understand what, if any, actions they can take to make the position better. Alongside this, HMRC is increasingly focused on risk-based reviews of company tax affairs. Accelerating inflation means that companies need to be aware of thresholds that require them to take action that in less inflationary times would have seemed less relevant.

Inflation will run at higher than 7% by Spring 2022 according to the Bank of England – not far short of four times the Bank of England's target and well in excess of the 5% predicted in late October at the time of the Budget.

The increase in prices is increasing the nominal size of the economy, thus driving tax receipts. In cash terms, the economy is forecast to be a lot larger in 2025/26 than was expected a year ago. At the time of the last Budget, this was expected to create around £50 billion of additional tax receipts. 7% inflation should produce even more tax for the government in cash terms.

Remember that 7% inflation halves the value of money in 10 years, which impacts the real value of corporate as well as government debts. Geared companies can expect to make a windfall which may offset some of the increased costs of taxation.

It is vital that companies are aware of the impact of an inflationary environment on their tax position and make sure they plan appropriately. The potential impacts are broad and far-reaching.

Tax rate hike

From 1 April 2023, corporate tax rates on profits above £250,000 are going to increase from 19% to 25% – a 31% increase in the rate. If corporate profits remain flat, shareholders can expect a decrease in post-tax returns – that's without any inflationary pressures coming through the supply chain. The small profits rate of 19% remains in place for profits of up to £50,000, with taper relief of up to £250,000 – except for close investment holding companies. By 2023, these limits will be worth less in real terms than when the legislation was passed, pulling more companies into a higher tax rate.

Where possible, companies may want to consider deferring the use of losses until 2023, thereby saving an extra 6%. This could represent a higher return than can currently be achieved on cash holdings. The impact of fiscal drag on tax payment date is discussed below and it will be important that companies are on top of their payments to ensure they retain a low-risk tax rating.

Increase in employers' national insurance

Employers will have to pay an additional 1.25% national insurance on payroll (an above inflation 9% increase). While NICs are tax deductible, reducing the net cost of the increase to around 1%, this represents a further cost to the business. Employers may want to review the use of salary sacrifice schemes, which can result in savings in national insurance to both employers and employees. However, most benefits fall within the optional remuneration arrangements rules, when there are no savings.

National minimum wage

The NMW is to increase to £8.91 per hour. When the chancellor announced this, the rise was well above the rate of inflation, but on current predictions it seems unlikely to match the rate. Further increases are to be expected. Enforcement of the NMW is rightly vigorous and companies should not take shortcuts to maintain profitability. Failure to meet the requirements can result in public naming and shaming.

VAT thresholds

The VAT threshold remains fixed at the 2017 level of £85,000. Businesses that make taxable supplies above this level need to register for VAT. Once registered, a business needs to make regular filings and deal with more administration. This needs to be monitored regularly as there are penalties for late registration.

Inflation of 7% reduces the real terms value of the threshold to just under £79,500 after a year. This doesn't just impact microbusinesses; it has a knock-on effect on the value of the thresholds for registering for the flat rate scheme, cash accounting and the annual accounting scheme. The thresholds remain fixed, but the real terms value can decline rapidly, forcing changes to the VAT position. Companies need to monitor revenue in response to increasing inflation and ensure that all registrations remain appropriate.

Tax payment date

Companies and groups that make taxable profits of less than £1.5 million pay their tax nine months and a day after the end of the accounting period. Those with profits over this threshold have to pay their taxes earlier (in some cases 18 months earlier). With 7% inflation this limit is £100,000 less in real terms after the first year.

Companies that manage to keep profits in line with inflation will quickly find themselves paying tax earlier, potentially changing their cash-flow profiles and funding requirements. The thresholds need to be divided by the number of worldwide group companies – so even quite small subsidiaries can find themselves having to make accelerated payments. Good advance planning is required, monitoring profits and cash, and understanding when the thresholds may be breached.

Superdeductions

Superdeductions for capital spend will start to fall away from 1 April 2022. The enhanced 130% deduction for capital spend is due to be phased out on 1 April 2023. However, due to the way the tax legislation was drafted, companies with accounting periods starting after 1 April 2022 will find the tax benefit is reduced through time apportionment. This little-noted effect means that taxable income may be higher than anticipated in future years, especially with the increase in tax to 25%. Companies should carefully plan their capital spend to ensure that they get the maximum benefit of the enhanced allowances available. Good records will be required to cover the always contentious issues of cut-off between the different regimes. HMRC can be expected to take a keen interest in this.

Interest deductions

Companies can deduct interest of up to £2 million a year with few restrictions. Above this level, interest deductions are restricted to (broadly) 30% of the company’s profits. Increasing inflation may result in increased nominal profits, making more interest potentially deductible. Any benefit may, of course, be offset by increased interest rates – but the ability to deduct a portion of the increase (at the higher 25% rate) may provide some comfort to corporate taxpayers that are able to pass on cost increases to their customers.

The law is complex and confusing, but interest deductions have a material impact on tax liabilities. Finance departments will want to have good models to forecast and update their projections to understand the after-tax cost of capital and minimise the risk of errors in calculation and reporting.

Transfer pricing

In times of inflation, we can be confident that tax authorities will expect that intra group transactions are priced to reflect changing markets. In a low inflation environment, reviewing the pricing maybe once a year might be acceptable. In a more volatile high inflation environment, contract terms and repricing could be expected on a more frequent basis.

Where the parties are in countries with differing inflation rates, squaring off an appropriate pricing structure will be an added level of complexity. Inflation expectations and interest rates can cause currency fluctuations, which in turn means that arm’s length prices will be less stable in times of higher inflation.

The threshold for UK companies having to comply with the full transfer pricing requirements are €50 million turnover and a balance sheet total of €43 million. These haven’t been adjusted for a number of years. With inflation running at 7%, the real terms value of these thresholds declines significantly.

Companies that have been able to take a light-touch approach to their transfer pricing could quickly find themselves needing to get their documentation in order. It is probably worthwhile for such businesses to start thinking about what documentation they need to have in place and identifying those transactions that might need to be reviewed. Waiting until HMRC asks the questions is unlikely to produce the best results.

Senior Accounting Officer

Companies with turnovers in excess of £200 million and/or balance sheet totals of more than £2 billion are required to appoint an individual to take responsibility for the maintenance of systems that can report tax liabilities. Again, these apparently high thresholds can be quickly eroded. Two years of 7% inflation would reduce the threshold by a little over £25 million in real terms, pulling more companies into the regime and increasing the risk of penalties and fines.

International matters

The UK is not alone in having complex, threshold-driven, cliff-edge tax provisions. Companies operating overseas need to understand the local regime, the expected growth in revenues and costs and make sure they understand the impact of the local inflationary environment on compliance.

The impact can also be seen in the UK. Controlled foreign company provisions are designed to stop UK groups from rolling up profits in locations with low tax rates. Some of the exemptions depend on there being limited sales – higher inflation can cause the nominal value of the sales to increase and thus change the reporting position. Companies should be managing the risk of non-compliance by having a detailed understanding of how the exemptions work and the impact of inflation on them.

In summary

A combination of inflation and tax rises will mean that laws designed for larger businesses will apply to some smaller ones. Companies are seen as a prime source of revenue for a Treasury needing cash. Allowing fiscal drag at a time of generationally high inflation and tax rates will prove lucrative to the Chancellor. His last Budget did much of the pitch rolling for these tax rises and talk of stealth taxes has focused mainly on individuals. Inflation will prove a valuable friend in extending their reach.

Some of the effects are unavoidable, but companies can take steps to mitigate the worst of them by careful planning and monitoring of the situation. Failure to do so will lead to even more unpleasant surprises.