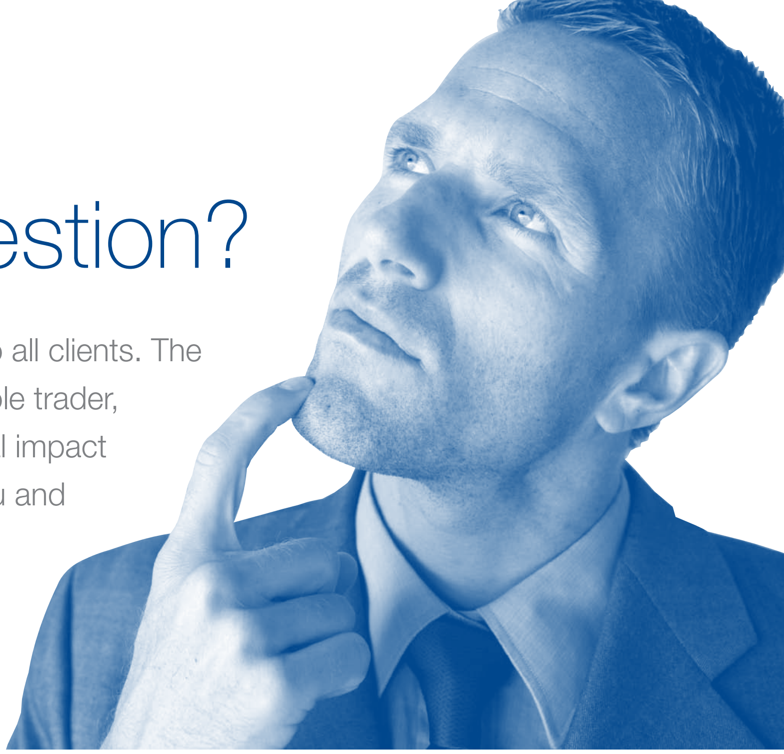
Incorporation or Non Incorporation
- that is the tax question?



Operating a business tax efficiently is a key concern to all clients. The choice of a suitable business medium, for example, sole trader, partnership or limited company may have a substantial impact on the level of reliefs, allowances and tax levied on you and your business. It is therefore essential to review the key issues to enable you to minimise tax liabilities. The briefing also introduces the issues which impact on changing your business structure from unincorporated to a company.

Tax and National Insurance (NIC)

Throughout this section it is assumed that the individual or company has no other income or profit chargeable to tax and that no other expenditure or relief is available to relieve tax charges.

Unincorporated business

The taxable trading profits of a business run by an individual as a sole trader are taxed directly on the owner, irrespective of whether the owner draws the money from the business for personal use. The same applies to the profit share of a general partner in a partnership (including a member of a Limited Liability Partnership). The principle applies for both income tax and NIC.

Currently this means that a sole trader or partner whose taxable profit does not exceed £100,000 will be charged to income tax as follows:

- the first £6,475 is tax free due to the availability of the personal allowance
- the next £37,400 is charged at 20%
- any further profits are charged at 40%.

Where taxable profits exceed £100,000 additional rules impact which increase the tax charge.

If overall income (less certain reliefs) is in the range £100,000 to £112,950 the personal allowance of £6,475 is reduced by £1 for every £2 in excess of £100,000 so that there is no tax-free allowance once income reaches £112,950.

In addition, the higher rate tax of 40% only applies until profits reach £150,000 then the excess profits are taxed at an additional rate of 50%.

The position for NIC is more straightforward. All self-employed earners who expect profits in excess of £5,075 are liable to pay Class 2 of £2.40 per week. This is usually settled by direct debit monthly. In addition, Class 4 is paid on taxable trading profits as follows:

- the first £5,715 is NIC free
- the next £38,160 is charged at 8% and
- any excess is charged at 1%

Tax tip

A business starts initially as a sole trader but later a legal partnership is formed with the spouse sharing profits equally. Tax savings may result depending on the precise circumstances. For example, where the spouse was not previously employed by the business and had no other income, a net overall tax saving of £3,723 could be achieved if the original sole trader business currently had profits of £60,000. This saving assumes that both spouses would be subject to Class 2 and 4 NIC.

The incorporated business

When the trade is carried out in a company, the company not the individual initially suffers the direct tax charge on the taxable profit. The rate depends on the level of profit but all corporation tax (CT) rates are lower than the personal higher and additional rates of tax. The effective rate of tax for a company not associated with any other company is

- 21% for the first £300,000
- 29.75% for the balance provided profits do not exceed £1.5 million and
- 28% flat rate for companies with profits in excess of £1.5 million.

What does this mean for the individual as owner?

The owners who are generally both shareholders and directors only suffer tax and NIC on any profits extracted from the company, so any profits retained in the company are sheltered from personal tax rates.

There are a number of different methods of extracting profits but again tax rates and NIC may need to be considered to minimise liabilities. Currently, significantly lower tax liabilities can arise on capital gains compared to income extraction but this is generally only available in limited circumstances such as when the individual sells their shares or the company is liquidated. In the meantime, director/shareholders will need to extract income for personal living and this has a tax and in some cases a NIC cost.

The two common methods used are remuneration and dividend. Tax relief is generally available for director/employee remuneration including NIC costs but not for dividends.

Remuneration

Any form of cash remuneration (salary, bonus, fees) and taxable benefits (medical insurance, car etc) are taxed as employment income attracting the normal income tax rates as outlined earlier. In addition employed income (excluding benefits) attracts Class 1 NIC for both the individual and the employing company. This is 11% for the individual on any income in excess of £5,715 up to a limit of £43,875, then 1% on any excess.

The employer is liable for 12.8% Class 1 on all earnings in excess of £5,715 with no upper limit and although employees are not liable to NIC on benefits, generally Class 1A NIC is due from the employer at the same 12.8% rate.

Dividend

When a dividend is paid to an individual it is subject to different tax rates compared to other income. The rates (as applied to gross income are):

- Basic rate taxpayers 10%
- Higher rate taxpayers 32.5%
- Additional rate taxpayers 42.5%

The overall tax cost effect on the company and the individual of comparing the extraction of a dividend with remuneration as a bonus is as follows:

> **Example**
>
> Simon wishes to extract £30,000 after all tax costs from his owner managed company to pay for his daughter's wedding. He is a 40% taxpayer and due to his existing company salary any NIC cost would be 1% only. The cost to the company of paying a dividend is £40,000 irrespective of the company's own tax rate. The respective net tax cost for the company of voting a bonus would range between £40,292 - £45,311 depending on whether the corporation tax relief on the bonus and related NIC was at a rate of 21/28/29.75%.

Dividends are often used in combination with remuneration to obtain the most tax effective extraction of profits when the business is carried on through a company but how does this compare with the sole trader or partner generating taxable profits in an unincorporated business?

To consider this let's look at an example of a sole trader David with a £60,000 profit and compare his position with Gordon who runs a similar business through a company and who has also made a £60,000 profit before any director's remuneration. Gordon has decided to take out a salary of only £5,715 because this means he will get an appropriate NIC credit for certain state benefits including state pension without an NIC charge. There is also no income tax as it is below the personal allowance. The rest of the profit after corporation tax is deducted will be extracted as a dividend. The overall tax and NIC saving of incorporation at this level of profit for 2010/11 would be £3,734. Whilst this shows that tax savings can be achieved by carrying on a business through a company, tax should not be the only factor considered before incorporating a business.

Effective use of losses

One of the reasons many businesses start off as unincorporated is that the reliefs available to relieve any trading losses are generally more comprehensive and flexible than the equivalent available to a new company. The idea is that losses are more likely in the early stages of business development so early and effective use not only saves tax but is cashflow beneficial.

> **Example**
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> A new trader incurs modest losses of £15,000 in each of his first two years. He has no other current income as he is investing his savings in the new business. However, prior to starting the business he was in employment and in the previous three years had earned around £60,000 each year.
>
> Under income tax loss relief provisions, he will be able to relieve both losses against previous income on which he suffered 40% tax obtaining a refund of £12,000 which will be a useful additional injection into the new business.
>
> If he had started this new business as a company the combined £30,000 loss would only be available for carry forward against future trading profits as they arise.

The recent recession has also demonstrated that losses can hit an established business. In this situation many traders and companies are able to relieve losses against previous profits and obtain refunds subject to certain conditions. This is also the case generally where a tax loss is created even though the business is profitable. This can occur if a business incurs significant plant and machinery expenditure due to the availability of tax relief. The Annual Investment Allowance on qualifying expenditure (not cars) currently provides 100% relief on up to £100,000 annually (limited to £50,000 before April 2010).

> Do contact us early if business circumstances indicate that losses are likely or you are planning new investment in plant so that we can assist you to maximise your opportunities.

CGT reliefs

The main relief available to business owners to reduce gains on certain disposals is Entrepreneur's Relief (ER). This is available to reduce gains of up to £2 million (£1 million before 5 April 2010) on a qualifying material business disposal and applies to both unincorporated business interests and company shares. The impact of the relief is that it reduces the effective rate of capital gains tax from 18% to 10%. A property personally owned but used in a trading partnership or company may also qualify. Detailed conditions apply and it is important to plan at least 12 months ahead to secure the relief effectively. For example an individual with trading company shares must have held 5% and be an officer/employee for the 12 months leading to the disposal.

To achieve effective capital extraction detailed conditions must be met. The CGT rate may also change following the Budget on 22 June 2010 so contact us for further information.

Business Property Relief (BPR)

Similarly the key inheritance tax (IHT) relief for trading businesses is generally available at a rate of 100% for both unincorporated business interests and unquoted company shares on lifetime gifts and at death. This generally saves IHT at 40%. Where a trading property is not held on the balance sheet of a partnership or a company as it is personally held outside the business, this will only qualify for 50% BPR at most. Further in relation to a property used in your trading company there is a risk of no BPR being available unless you have and retain control of the company's voting power.

Impact of incorporation

If circumstances induce you to incorporate your existing unincorporated business to obtain income tax and NIC savings, there will be a number of factors for you to consider.

Key non tax factors include being aware of the legal and accounting formalities of operating a company which usually result in higher professional fees and ensuring that practical matters of the transfer are considered, for example, new business stationery and informing customers, suppliers and the authorities like HMRC and even the DVLA!

Incorporation means the trade ceases for income tax and a new trade starts in the company. This may lead to profit distortions in the final period if careful planning is not considered. It also often involves the disposal of assets to the company which impacts upon both capital allowances and capital gains. Properties are often retained in personal ownership. This is generally done to minimise the overall tax charges on a future disposal (of the property) as corporation tax would arise on any gains and also personal tax on extracting the rest of the profit. It also avoids Stamp Duty Land Tax which would apply on the transfer. Gains can also arise on the transfer of goodwill.

Gains which do arise may be reduced to a 10% effective rate of tax using ER whilst the capital gains tax rate remains at 18%.

Planning is needed in particular to

- Maximise the capital allowance position for your circumstances
- Minimise the impact of tax liabilities including IT, NIC and CGT
- Consider the cash flow impact of the timing of any tax payments on changeover
- Obtain valuations of assets particularly the goodwill of the business
- Ensure CGT reliefs are maximised

Once in a company structure any decision to transfer back to being an unincorporated business is also a trade cessation with a disposal of chargeable assets. The critical difference is that there are fewer reliefs available for such a 'disincorporation to ensure the process is tax efficient. This emphasises the point that long-term considerations should be taken into account as well as short-term tax advantages in choosing and changing business structure.

Many of the issues contained in this briefing have detailed rules which must be properly considered to achieve the desired outcome, so please contact us to review the areas suitable for your specific aims.

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