Incorporation - Tax, Accounting and Commercial Considerations

BUSINESS TAX GUIDE

October 2015

OVERVIEW

With corporation tax rates now harmonised for small and large companies alike and with added incentives (such as R&D and creative sector reliefs) only available to companies, many sole traders and partnerships (including LLPs) are considering the merits of 'incorporating' the business.

Tax is often not the principal driver for the decision. Rather it is other key commercial factors such as limitation of liability, share incentivisation for key employees and the lower tax cost of retaining and reinvesting working capital in the business, which assist the business owner in making his or her decision.

Is 'incorporating' the right thing to do?

Whether 'incorporating' is appropriate for the business is very much dependent on an array of objective and subjective factors. Business owners contemplating the change should consider, amongst other things:

- longer term strategic aims
- business succession
- exit strategy
- employee incentivisation
- owners' lifestyle and cash requirements from the business
- client/customer perception of the change

There will likely be no single imperative factor to drive the decision to incorporate but it will be based on the overall pros and cons of doing so.

At Rawlinson & Hunter, we are very experienced in helping business owners make the decision which is ultimately right for them and their business. This guide explores some of the tax, accounting and commercial issues which need to be considered alongside those above.

Tax on business profits

Sole traders, partners and individual members of Limited Liability Partnerships are subject to Income tax (at up to 45%) and Class 2 & Class 4 National Insurance. Higher rate and additional rate taxpayers are therefore subject to tax and national insurance charges of up to 42% and 47% respectively on those business profits.

The corporation tax rate for companies is presently 20%.

Tax on dividends

Whilst companies are subject to corporation tax on their business profits at a rate of 20%, there is a double layer of taxation which comes into play if the business owners wish to extract these post-tax profits.

There are a variety of mechanisms (and combinations thereof) for extracting profits from a company. The most straightforward route tends to be the payment of dividends to the company's shareholders.

Dividends are taxable income for the individual shareholder and reportable on their tax return for the tax year of receipt of the dividend (or the tax year where a final dividend is declared by the company, irrespective of whether the dividend was physically paid at that point).

Currently, dividends for basic rate taxpayers have an effective rate of 0% (the logic being that those profits from which dividends have been derived have already been subject to corporation tax at 20%). For higher rate taxpayers (broadly total taxable income between £50k and £150k per annum), the effective rate of tax is 25%. For additional rate taxpayers (those with taxable income in excess of £150k per annum), the effective rate of tax on the dividend falling into the additional rate band is 30.56%.

If a business owner who is already an additional rate taxpayer were to extract each £ of profit from the company as it is earned (leaving sufficient behind to pay the corporation tax liability), the net tax cost would equate to 44.4% of the underlying profit. This is still preferable to the 47% (tax and national insurance) payable as a soletrader/ partner.

However, incorporation is a long term decision and the Chancellor's announcements in the recent Summer Budget 2015 have made significant changes to the way dividends are taxed from April 2016. Subject to the availability of a £5,000 exemption, dividend tax rates will increase within all tax bands by 7.5%. Therefore, for an additional rate taxpayer, the net cost would be 50.5% making this route more expensive than the sole trader/partnership route.

In reality, many business owners will only draw sufficient dividends from the company to satisfy their personal needs, leaving the remainder of profit retained in the company for reinvestment in the business. Therefore, there is also a benefit in terms of timing of tax cashflows.

Tax cashflows

A sole trader's or partner's income tax liability and national insurance contributions for a tax year are due to be paid in two half-yearly payments on account, on 31 January in the tax year and the following 31 July, after the tax year. The payments are based on the previous year's tax liability and any additional liability is payable on the next 31 January.

HMRC's payment terms for companies are less generous. Corporation tax is due 9 months and a day following the end of the company's accounting period unless the company is large enough to be caught by the quarterly instalment payment ('QIPs') regime.

Broadly, QIPs applies if profits are £1.5m or more in a 12 month accounting period. Payments commence in month 7 of the accounting period and this first instalment is followed by three quarterly instalments thereafter.

An individual shareholder extracting post-tax profits by way of dividend can plan to maximise the deferral of the income tax liability by timing the dividend payment shortly after the end of a (personal) tax year making two half yearly payments on account and a balancing payment (as above) a year later. If, on the other hand, the shareholder chooses to take out profits by way of salary and bonus, then PAYE and NIC will be due on the 19th/22nd of the month following payment. See our 'Profit extraction - Dividends vs Salaries & bonuses' Business Tax Guide for more information.

Loss relief

The rules for sole traders and partners recognise that there is no legal division between the individual and the trade. Trading losses can therefore be offset against 'general' income, such as other sources of private income of the individual.

The rules for such 'sideways' loss relief allow the offset against income of the same year, and either or both of the preceding year, but the relief is subject to a number of anti-avoidance rules. There is now also a cap on the sideways relief available limiting this to £50,000 of loss in any particular tax year, or 25% of the taxpayer's total income if this is greater.

Different rules apply to restrict the use of different types of tax loss made by a company. However, in general terms, a tax loss incurred by a company can be used only to set-off against other profits made by the same company or, if relevant, companies in the same group.

Trading losses, for instance, can be offset against profits and gains of the same or preceding period. Otherwise they are automatically carried forward to offset against profits of the same trade, unless the company chooses to surrender the loss to a group company.

Limitation of Liability

Most partnerships will be formed as limited liability partnerships and therefore unlimited liability is generally only applicable to sole traders or traditional unincorporated partnerships.

Directors or shareholders can be requested to give personal guarantees in favour of lenders to the company lifting the limited liability of the individuals. Rarely, it is also possible for courts to ‘lift the veil of incorporation’ such that directors are personally liable for losses incurred by the company though, for this to be the case, there has to be demonstrable fraudulent or wrongful trading taking place within the company.

Financing the business

Companies are often better able to arrange financing. However, lenders to companies with limited track records will often seek to minimise their risks by demanding personal guarantees from key directors or shareholders or impose limitations on the company on what it can pay out in the form of dividends.

Transferability of business interests

The tax regime positively encourages business ownership and offers tax breaks for the transfer of business interests.

Transfers of share ownership in a company can be both easier and harder than transferring business interests in an unincorporated business. Much really depends on personal circumstances and what is trying to be achieved.

Flexibility of profit sharing

Partnerships have historically offered a great deal of flexibility in sharing profits amongst partners. The partnership agreement determining capital and revenue profit shares can easily be changed for existing partners, as well as allowing new partners to join and partners to leave profit sharing arrangements.

Companies are generally less flexible. Company law strictly regulates the issue and redemption of shares and any single class of shares must give the same rights to income and capital. Flexibility can be generated by creating separate share classes with different rights for different individual shareholders. These are best identified prior to incorporation. Care must be taken in issuing shares post-incorporation to directors or employees as anti-avoidance rules can tax the growth in value of shares as employment income.

Administrative burdens

The benefit of limited liability for companies brings with it additional regulatory and administrative burdens:

- Directors’ board meetings and maintenance of minutes
- Annual general meeting and other meetings of shareholders
- Provision of financial accounts to its shareholders
- Statutory filing requirements with Companies House including an annual return and financial accounts (although in an abridged form for small companies)
- Statutory audit of the company’s accounts (but small companies are exempt*)

** A company is small for this purpose if two of the following three thresholds are not exceeded (from 1 January 2016): turnover is below £10.2 million, assets are below £5.1 million, and employees are below 50.*

Legal duties

Many sole proprietors, in particular, who have incorporated their businesses in the past have struggled with the concept of the company’s assets being legally distinct from their own, this is, of course, only natural.

As a director of a company however, the principal responsibility is to the shareholders and creditors of the company. Before embarking on a company directorship, legal responsibilities should be discussed with a lawyer.

Mechanism for incorporation

Incorporation will typically involve the transfer, by the sole trader or partnership, of the trade and assets of the business to the newly incorporated company. For tax purposes, it means the potential for capital gains tax on gains on the disposal at market value of goodwill, property, and possibly other chargeable assets .

Broadly speaking, if the consideration for the business transfer is the allotment of shares to the business owner(s), any gains will be deferred by being rolled over against the value of the shares; so-called Incorporation Relief.

However, Incorporation Relief relies on all business assets being transferred. This is often considered as too restrictive, particularly for a business which has a significant property asset. The Stamp Duty Land Tax cost of transferring the property will be unattractive and retaining it personally may give the owner the option of extracting profit by way of rent. It is therefore not unusual for Incorporation Relief to be disapplied and for the owner to instead seek to defer gains (particularly on goodwill) under Gift Relief. If goodwill is gifted or sold for a nominal amount to the company, the gain on the deemed market value is held over until the goodwill is sold on.

How can Rawlinson & Hunter help?

With a number of aspects to consider, which are unique to the business and its owners, professional advice is essential on deciding how to structure the operations. Rawlinson & Hunter have a wealth of experience on advising a number of different business types and we are well placed to tailor advice to your needs.

If you are interested in further information in this regard, please contact the Rawlinson & Hunter partner who normally acts for you. Where you are not one of our regular clients, please contact Craig Davies or Andrew Shilling, who would be delighted to discuss this with you in more detail.

Craig Davies

Direct Dial: (+44) 20 7842 2136

Email: craig.davies@rawlinson-hunter.com

Andrew Shilling

Direct Dial: (+44) 20 7842 2135

Email: andrew.shilling@rawlinson-hunter.com

Rawlinson & Hunter

Eighth Floor
6 New Street Square
New Fetter Lane
London EC4A 3AQ

And at

Lower Mill
Kingston Road Ewell
Surrey KT17 2AE

T +44 (0)20 7842 2000
F +44 (0)20 7842 2080

firstname.lastname@rawlinson-hunter.com
www.rawlinson-hunter.com

Partners

Chris Bliss FCA
Simon Jennings FCA
Philip Prettejohn FCA
Mark Harris FCA
Frances Jennings ACA
David Barker CTA
Kulwarn Nagra FCA
Paul Baker ACA
Sally Ousley CTA
Andrew Shilling FCA
Craig Davies FCA
Graeme Privett CTA
Chris Hawley ACA
Phil Collington CTA
Toby Crooks ACA
Michael Foster CTA

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