

# Essential Guides



Incorporation



## Introduction

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This section considers the advantages and drawbacks of using a private company when starting to trade, or later once a business has become established. It also summarises company formation procedure. People starting in business generally risk financial loss. As far as possible, they will want to ensure that:

- Personal assets are safeguarded.
- The financial position of the family is protected in the event of illness or death.
- Tax liabilities are minimised.
- Adequate finance can be obtained for establishing or expanding the business.

Trading as a limited company, rather than as an individual or in a partnership, sometimes helps to achieve these objectives. However, it can involve drawbacks and extra costs.

Selecting the right trading vehicle from the start will avoid the problems and costs of incorporating or disincorporating. But it is not always easy to decide, because it might be difficult to forecast how the business will develop. If there is any doubt about whether a company is the best vehicle, the business should be started as a sole trader or partnership. Tax legislation makes incorporation far less costly than disincorporation.

### Tax issues

Tax is a particularly important issue when deciding whether or not to incorporate. The decision depends on the business and on the individual's personal and financial circumstances. Individual calculations have to be made. The entrepreneur has to weigh up the advantages of incorporation (eg corporation tax at the small profits rate on up to £300,000 of profits) against the benefit of remaining a sole trader (eg lower national insurance contributions (NICs) than on director's remuneration paid by a company, and ease of extracting money). Often, it is a question of how much sophisticated tax planning the individual wishes to undertake.

Following several years of changes to tax rates, the basic rate of income tax, at 20%, is now 1% lower than the small profits rate of corporation tax of 21%. However, this rate will fall to 20% from April 2011. This has reduced the tax advantages of incorporation for the smallest businesses. However, where a sole trader would have significant profits within the 40% or 50% income tax band, incorporation can still be beneficial.

### Incorporating an existing business

This section discusses (on page 15, 'Transfer of an existing business to a company') the procedures for transferring an existing business to a company. It can be beneficial to delay incorporation of a new business, because any trading losses in the opening years of an unincorporated business can be relieved against the owner's income tax for the three previous years. Trading losses would also prevent an incorporated business avoiding high NICs by paying dividends instead of remuneration, so removing much of the tax benefit that can be gained by incorporation.

Generally, incorporation becomes desirable once profits reach a certain level, but incorporating an existing business can result in:

- A large income tax assessment in the final year of trading, depending on the accounting date and other factors.
- Stamp duty land tax (SDLT) costs if freehold or leasehold property is transferred to a company.
- Professional fees.

These might outweigh any initial tax savings.

## Setting up a company

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The Companies Act 2006 introduced a number of provisions which have an impact on company formations. The provisions of the Companies Act 2006 were implemented in stages. Many of the changes affecting the matters dealt with here were implemented from 1 October 2009.

### Company names

Before preparing or submitting documents of incorporation (see below), a check should be made against the Index of Company Names kept by the Registrar of Companies. This service is available on the Companies House website at [www.companies-house.gov.uk](http://www.companies-house.gov.uk).

- A name is not acceptable if it is the same as, or similar to, one already on the index.
- Some names require special approval.
- Objections to a name can be made on the basis that:
  - It is similar to an existing company name being used by the person complaining.
  - Its use in the UK could mislead by implying a connection to an existing company name.

### Documents of incorporation

Here we are dealing only with the formation of companies on or after 1 October 2009, as regulated by the Companies Act 2006.

The documents which will need to be delivered to Companies House are:

1. Memorandum of association
  - The memorandum is now more limited in scope than it was under previous legislation
  - It is a statement that the subscribers wish to form a company, agree to become members and, where the company is to have a share capital, agree to take at least one share each.
  - Information about the proposed company's name, its registered office, limited liability and the total number of shares taken by subscribers will be dealt with in the other registration documents (see below).
  - An objects clause is not now required because under the 2006 Act every company has unrestricted objects. However, a company may choose to restrict its objects in its articles.

2. Articles of association

Regulations arising under the 2006 Act contain model articles for each of the main type of companies which may be formed. These models are now treated as the 'default' set of Articles, but they may be modified if the company so chooses.

3. Application for registration

This states the company's name, whether liability is to be limited by shares or guarantee and whether the company is to be public or private.

4. If the company is to have a share capital, a statement of its share capital and initial shareholdings.
5. A statement of the intended registered office of the company.
6. A statement of the first directors and secretary (unless in the case of a private company there is no secretary), together with a statement that the requirements of the 2006 Act have been complied with.

## **Certificate of incorporation**

When the Registrar has accepted the documents and company name, a certificate of incorporation is issued to bring the company into existence.

## **Company formation specialists**

Ready-made and tailor-made companies can be bought from company formation specialists.

This is useful where a company is needed instantly.

They also often offer a free name check.

## **Start-up costs**

- Apart from any professional fees, a registration fee of £20 is payable, or £50 for same-day incorporation.
- If incorporation is carried out electronically, the fee is £15, or £30 for same-day incorporation. Special software is needed.
- The cost of a company from a formation agent starts at around £50, including the £20 registration fee, for a basic package.

The documents needed for incorporation can be obtained from Companies House on 0870 333 3636 or through the Companies House website ([www.companies-house.gov.uk](http://www.companies-house.gov.uk)), and model sets of articles of association can be obtained from legal stationers.

Other costs arise from the need to maintain:

- Minute books for recording meetings of directors and shareholders.
- A book of share certificates.
- Registers of members and share transfers.
- A register of the directors and secretary.
- Registers of debentures and other charges, if any.
- Books of account or appropriate computer software to record details of payments and receipts, debtors and creditors, and other assets and liabilities.
- A method of displaying the company name at the registered office and at all places of business.
- Printed letterheads, stationery, and other business documents, which must by law show the company's registered name. Most business documents must also show its registered office address, place of incorporation and registered number.

The first five items are often combined into one register, which a company formation agent can supply with the company package for an additional fee. It is not necessary to have a company

seal, and small companies do not normally need one. Accounting records and business stationery are necessary for any well-run business, whether or not incorporated.

## Annual costs

In addition to start-up costs, companies incur annual costs.

- A limited company is obliged to file annual accounts with the Registrar of Companies. There are strict penalties if a private company fails to file accounts on time.
  - For accounting periods starting after 5 April 2008, the filing date is nine months after the year end, or 21 months after incorporation for the first period.
  - Penalties start at £150 for a delay of up to one month. Accounts one to three months late attract a penalty of £375, with £750 for a delay of three to six months and £1,500 for a delay of more than six months.
  - The penalties are doubled if accounts are filed late a second time in succession.
- Small companies with turnover of £6.5 million or less and a balance sheet total of not more than £3.26 million do not need an audit. Accounts still have to be prepared in the form required by the Companies Act and accounting regulations, which means professional fees are likely to be higher than for a sole trader.
- Since October 2007, a private company no longer has to hold an annual meeting of shareholders, unless at least 10% (5% in certain circumstances) of its shareholders want one.
- An annual return must be filed with the Registrar of Companies, for which the filing fee is £30 if filed on paper or £15 if filed online. No special software is needed for online filing.
- Companies House sends annual returns automatically to all 'live' companies, other than those that file online, and these days most of the information is pre-entered and needs only to be checked.
- Companies that file annual returns online receive a reminder letter. The online filing process consists of updating the information held at Companies House if necessary and payment of the filing fee.

Well-run companies should not incur penalties for late filing. In recent years, authorities such as HM Revenue and Customs (HMRC) have imposed tighter compliance regimes on all businesses, whatever their legal status. This means that all businesses must keep their records in good order and up to date.

## Advantages and drawbacks of a limited company

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Trading as a limited company has advantages and drawbacks. The main difference is in taxation and national insurance:

- The non-tax considerations are dealt with in this section.
- Tax and national insurance are covered on page 7, 'Tax considerations'.

### Limited liability

After they have paid for their shares, the members of the company have no further liability to contribute towards debts incurred by the business.

However, limited liability might not provide complete protection from the company's debts.

- Directors must beware of knowingly incurring debts that they have reason to believe the company will be unable to pay. This could result in the directors facing legal action for wrongful or fraudulent trading, and can lead to disqualification as a director. In liquidation, the court could order a director to contribute to the company's assets if there is evidence of wrongful or fraudulent trading.
- Banks, landlords and other creditors might seek security in the form of personal guarantees from directors to back the company's credit and might require loans to be secured on a director's personal assets.

## **Continuity of management**

The management of a company might be separate from its ownership. Management of the business can then continue in spite of any changes in shareholders. Employees can be promoted to senior management positions without necessarily holding any shares in the company.

## **Access to funds**

- Some suppliers and providers of finance might prefer to deal with companies rather than with individuals or partnerships because:
  - A company can be sued as a separate entity.
  - A company has continuity of management.
  - Companies can give security for borrowing by means of a 'floating charge' over the whole of their assets. This is not available to a sole trader or partnership.
- Conversely, some creditors might be happier dealing with sole traders or partnerships, which do not have the protection of limited liability.
- Several financial institutions offer finance to companies at various stages of development. This is normally referred to as venture capital. Prominent among them is 3i plc (formerly Investors in Industry), which typically offers packages of loan and equity capital to smaller companies.
- The enterprise investment scheme (EIS) gives individuals tax relief at 20% on investments up to £500,000 a year in qualifying companies. Individuals can also defer capital gains tax (CGT) liability by making EIS investments, resulting in initial total tax relief on an investment of 38% (20% income tax plus 18% CGT) for basic rate taxpayers. The initial relief is 48% (20% income tax plus 28% CGT) for higher and additional rate taxpayers.
- The main conditions are, very broadly:
  - Companies must have gross assets of not more than £7 million before the issue of EIS shares and not more than £8 million immediately afterwards. They must not have a stock exchange listing but can be listed on the Alternative Investment Market (AIM).
  - The company must exist mainly to carry on a qualifying trade in the UK. Property development, financial activities, leasing and operating hotels or nursing homes are among the trades that do not qualify.
  - For EIS shares issued on or after 22 April 2009, all of the funds raised by the company must be used for the purposes of the trade within two years of the later of the date of issue of the shares or the date the company commences trading.
  - The company must not have raised more than £2 million under the EIS (and similar schemes) in the 12 months up to the investment.

- The company must have fewer than 50 full-time employees (or their equivalent) when the EIS shares are issued.
- The investor must normally hold the shares for at least three years, after which any gain on their disposal is exempt from tax.
- Any losses qualify for income tax or CGT relief.
- For income tax relief, the investor must not be connected with the company, but can in limited circumstances become a paid director.
- Venture capital trusts (VCTs) are listed companies that invest in unlisted trading companies. An individual who invests in the shares of a VCT receives income tax relief of 30% on investments up to £200,000 a year and spreads the investment risk among several companies. However, investments cannot be used to defer CGT liability. Dividend income is tax-free, although the tax credit cannot be repaid.
- One drawback of corporate status is that a private company cannot invite the public to subscribe for its shares or debentures. If it wishes to do this, it must re-register as a public limited company (plc). This imposes additional formalities and more constraints on its activities:
  - A public limited company must have an issued share capital of at least £50,000.
  - At least 25% of the nominal capital and the whole of any premium arising on the issue of the shares must actually be paid in cash or some other consideration.
  - Public companies have a shorter period in which to file accounts and higher late filing penalties than private companies.

For further information on the EIS and VCTs see the separate topic 'Income Tax Basics: income tax calculation'.

## Drawbacks

Apart from the costs outlined on page 2, 'Setting up a company', trading as a limited company has some other disadvantages:

- The flexibility of the unincorporated business arrangement is lost.
- Companies must comply with Companies Act regulations.
- The obligation to file annual accounts with the Registrar of Companies means that the accounts are open to inspection by third parties. Small and medium-size companies, as defined by the Companies Act, can file abbreviated accounts, so that some information that could be useful to competitors, such as gross profit margins, does not have to be revealed. However, the government has proposed making all companies file full accounts. Sole traders and partnerships (other than limited liability partnerships, see page 17, 'Limited liability partnerships') do not have to file any information.
- Although the shareholders as a body can exercise effective control over the company's affairs, they cannot apply its assets to their personal use, nor can they withdraw funds at will.
  - Payments to shareholders are restricted to such dividends as it is prudent to declare.
  - As a general principle, loans by a company to its directors are prohibited by the Companies Act 2006 unless the approval of the members is obtained. There are a number of exceptions to this provision, for example, loans up to £50,000 for the purpose of enabling the director properly to perform his/her duties and other loans up to £10,000.

A case was reported where crooks 'stole' a company by filing forged forms at Companies House changing the directors. They were then able to carry out fraudulent transactions on the back of the company's history and credit ratings, unknown to the company's true directors. While this is rare, directors should be aware of the risk.

Directors can protect their companies themselves from this type of identity fraud by registering to file documents online and signing up to protected online filing (PROOF). Companies House will then accept changes of address and directors' details only if they are filed electronically (which requires security codes).

## Tax considerations

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Companies pay corporation tax whereas individuals, whether sole traders, partners or directors, pay income tax.

- The corporation tax rate for companies with small profits is 1% higher than basic rate income tax. However, the small profits corporation tax rate extends to a much larger amount of profits than the income tax basic rate band, so the comparison is often between 21% corporation tax and 40% income tax. From 6 April 2010, taxable income of an individual above £150,000 will be taxed at 50%. The small profits rate of corporation tax will reduce to 20% from April 2011. NICs on directors' remuneration and on sole trader and partnership profits also have to be taken into account.
- Whether incorporation saves tax overall depends on the level of profits, how much of the profits the company pays out and whether it does so in the form of dividends, salary or a combination of both.
- At low levels of profit, incorporation might not save tax and even if it does, the administrative costs and additional compliance might make it not worthwhile.
- In general, the corporate structure provides more flexibility and planning opportunities, especially with the salary levels that can be set for the owner/managers. However, national insurance complicates the situation.
- From 1 August 2008, small and medium-size companies can get tax relief on 175% of qualifying research and development expenditure. The rate before this date was 150%.

## National insurance

National insurance for an employee is a great deal more costly than for a sole trader or partner. Although it entitles the employee to greater state benefits, these might not be worth the additional cost.

- A sole trader or partner pays two classes of national insurance:
  - Class 2, which is a flat rate of £124.80 in 2010/11.
  - Class 4, based on profits. The rate in 2010/11 is 8% of profits between £5,715 and £43,875, giving a maximum of £3,052.80, plus 1% on all profits above £43,875.
- An employee's earnings are subject to Class 1 NICs:
  - The employer pays 12.8% on all earnings above £5,715 a year without a ceiling (2010/11).
  - The employee pays 11% on remuneration between £5,715 and £43,875, giving a maximum of £4,197.60, and 1% on all remuneration above £43,875 (2010/11).

- Even on a fairly modest salary of £40,000, the Class 1 NIC (employer's and employee's) of £8,160 is far higher than the Class 2 and 4 NIC of £2,868 on equivalent profits. The fact that employer's NIC is deductible against corporation tax does not go far to mitigate the cost.
- The employer is also liable to pay NIC at 12.8% on the value of any benefits in kind, such as medical insurance and company cars.
- The Class 1 and Class 4 NIC rates referred to above will increase by 1% for 2011/12.

Many companies can avoid NIC by paying out profits to director/shareholders as dividends instead of remuneration, whereas sole traders and partners cannot do this. Dividends can be quarterly or even monthly. However, there are difficulties and careful planning is necessary:

- Dividends normally have to be paid pro rata to all shareholders, although it is possible to have different classes of shares with different dividend entitlements. This is of course not a problem for small businesses with only one director/shareholder.
- Dividends are not included in earnings for pension scheme contribution purposes.
- Combining dividends with a salary of at least £97 a week (£5,044 a year) in 2010/11 gives entitlement to those state benefits available only to employees, with minimum NIC cost. Indeed, no NIC is payable where the salary is between £97 and £110 a week. Furthermore, any salary between £5,044 and £14,100 a year will accrue benefits under the State Second Pension (S2P) as if the salary were £14,100.
- The saving achieved by paying dividends instead of remuneration is lower for companies with profits of more than £300,000 than for companies with profits up to £300,000, if higher and additional rate income tax and corporation tax are taken into account as well as NIC. This is because of higher corporation tax rates.
- Under company law, dividends can broadly only be paid out of accumulated profits. A company that has made losses, for example, in the early years, might not be able to pay dividends.
- Personal service companies (commonly known as IR35 companies – see the separate topic 'Company Year End Tax Planning 2010/11') cannot avoid NIC through dividends. These are companies that provide the services of one or more individuals under a contract such that if the worker had contracted directly with the client under the same terms, the income would have been taxed as employment income under the rules that determine the boundary between employment and self-employment.

## Rates of tax on profits

The rate of corporation tax on company profits is generally lower than the rate of income tax on individuals.

- Currently there are three corporation tax rates in effect:
  - Companies with profits up to £300,000 pay tax at 21% (the small profits rate).
  - Companies with profits between £300,000 and £1,500,000 pay 21% on the first £300,000 and an effective rate of 29.75% on the profits in excess of £300,000.
  - Companies with profits of £1.5 million or more pay tax at 28% (the main rate).
- From 1 April 2011 the small profits rate will be reduced to 20%, and the main rate will fall to 27%. The effective rate on profits between £300,000 and £1,500,000 will be 28.75%. There will be further 1% reductions in the main rate in each of the following three years.

- These limits are shared equally among associated companies, that is, companies under common control, and are reduced proportionately for accounting periods of less than 12 months.
- Individuals have a personal allowance of £6,475 in 2010/11. However, the allowance is reduced by £1 for every £2 of taxable income above £100,000. If a taxpayer has income of £112,950 or more, the personal allowance will be reduced to nil.
- On income in excess of this allowance plus any other reliefs, they pay tax in 2010/11 as follows:

|                             |  |
|-----------------------------|--|
| <b>First £37,400</b>        | 10% on dividends   |
|                             | 10% on first £2,440 of savings income (only if total income is not more than £2,440) |
|                             | 20% on all other income  |
| <b>£37,401 to £150,000</b>  | 32.5% on dividends   |
|                             | 40% on all other income  |
| <b>Excess over £150,000</b> | 42.5% on dividends   |
|                             | 50% on all other income  |

- Dividends come with a 10% tax credit. This means that where dividends fall within the basic rate band there is no more tax to pay. Higher rate taxpayers have to pay a further 22.5% of the dividend plus tax credit, equivalent to 25% of the dividend itself. Additional rate taxpayers pay a further 32.5% of the dividend plus tax credit, equivalent to 36% of the dividend itself.
- Company profits paid to a director as remuneration, or to a shareholder as dividends, are liable to the appropriate rates of income tax. This limits the amount of tax that might be saved through trading as a company. The tax benefit is greater where a significant amount of profits can be retained within the company. Often the comparison is between 21% corporation tax and 40% income tax.
  - It might be possible to extract these profits in such a way that little further tax is payable.
  - For example, dividends could be paid in years when the shareholder is not liable to higher or additional rate tax, or the company could be sold or liquidated, giving rise to a capital gain on which entrepreneurs' relief in effect reduces the tax payable to 10%.

### Example of tax comparison

The following example shows the potential tax saving that incorporation can achieve in 2010/11 on business profits of £60,000.

It assumes that the individual is entitled only to the basic personal income tax allowance, and that after incorporation the individual is the only shareholder and draws a salary of £6,475 (to benefit from the personal allowance) and all the rest of the profits in the form of dividends.

### Example

|  | Self-employed  | Company      |
|--|----------------|--------------|
|  | £              | £            |
| Profits  | 60,000         | 60,000       |
| Income liable to income tax on individual                      | Profits 60,000 | Salary 6,475 |
| Income tax on the above  | 13,930         | -            |
| NIC  | 3,339          | 181*         |
| Corporation tax (21% on profits of £53,428)                    |                | 11,220       |
| (60,000 – 6,475 – 97)  |                |              |
| Dividend (£60,000 – £6,475 – £97 – £11,220)                    |                | 42,208       |
| Higher rate tax on dividend (£42,208 x 10/9 – £37,400) @ 22.5% |                | 2,137        |
| Net income after tax and all NIC                               | 42,731         | 46,365       |

\*This figure consists of employer's NIC of £97 and employee's NIC of £84 on the difference of £760 between the personal allowance for income tax (£6,475) and the NIC contributions threshold of £5,715. It is more beneficial, in terms of net income, to pay this NIC than to limit salary to £5,715 and pay a larger dividend.

The company owner might be able to reduce the tax liability by limiting the payment of dividends liable to higher or additional rate income tax if the income is not immediately needed.

## Capital gains

There are many differences in the way individuals and companies are taxed on capital gains.

- Individuals pay CGT on disposals of some business assets, such as land and buildings, goodwill, and shares.
  - The first £10,100 of annual gains is exempt.
  - The rest of the gains are taxed at 18% if the gains are made before 23 June 2010. From that date the rate of CGT is determined by adding the gains to the taxable income for the year. If the total is within the basic rate income tax limit (£37,400), the gains are taxed at 18%, but any gains which fall above £37,400 are taxed at 28%.
  - Entrepreneurs' relief reduces the tax rate to 10% on the first £2 million of gains realised before 23 June 2010 on the disposal of the whole or part of a business, or the disposal of assets after the business ends. The relief is available on gains of up to £5 million from 23 June 2010.
  - Entrepreneurs' relief is also available on disposals of shares in a personal trading company – a company in which the shareholder holds at least 5% of the ordinary shares and voting rights, and is a director or employee.
  - Availability of entrepreneurs' relief is subject to some conditions (see the separate topic 'Capital Gains Tax for Business Owners').
- Companies pay corporation tax on gains at normal corporation tax rates.

- Companies do not get an annual exemption. Indexation of the original cost of an asset ensures that only gains in excess of inflation are taxed.
- There are special rules for disposals of intangible assets, such as goodwill.
- Companies are not liable to tax on disposals of trading subsidiaries, subject to several conditions.

### Trading status

In order that a shareholder can qualify for entrepreneurs' relief for CGT purposes, the company must not have substantial non-trading activities, income or assets. HMRC generally interprets substantial as meaning more than 20%, but each case is considered on its own facts. Trading status may sometimes be difficult to ensure for a company. In contrast, an individual can easily ensure that particular business assets are only used for a trade.

### Two-tier capital gains tax

An individual who disposes of a business asset will pay CGT and then be free to use the remainder of the sale proceeds. When a company disposes of an asset and pays corporation tax on the gain, the company's owner might be liable to further tax when the proceeds are withdrawn. If the sale proceeds are not distributed as remuneration or as dividends, giving rise to income tax, it will eventually be necessary to sell or liquidate the company to obtain access to the money. This disposal could generate a second capital gain that is taxable on the shareholder.

It is difficult to make comparisons between the tax payable by an individual trader on the sale of business assets and the aggregate tax payable by a company and shareholder where an incorporated business sells assets and the shareholder withdraws the proceeds. This is because of the different effects of the indexation allowance and entrepreneurs' relief.

- Indexation will ensure that the company's gain is almost always lower than an individual's gain before entrepreneur's relief on the same disposal.
- Entrepreneurs' relief is only available in certain circumstances.

#### Example

In a very simple case, a company makes a gain of £125,000 before indexation and pays corporation tax of £21,000 on an indexed gain of £100,000, leaving the company with £104,000.

On a liquidation of the company, the CGT payable by a shareholder entitled to entrepreneurs' relief (ignoring the annual exemption) is:

$$£104,000 \times 10\% = £10,400.$$

Therefore funds retained are:

$$£104,000 - £10,400 = \mathbf{£93,600}.$$

If the individual had owned and sold the asset personally, the tax payable, assuming the disposal qualified for entrepreneurs' relief, would have been:

$$£125,000 \times 10\% = £12,500.$$

Therefore funds retained are:

$$£125,000 - £12,500 = \mathbf{£112,500}.$$

- The disadvantage of two-tier CGT is less where indexation is large compared to the gain.
- The problem of two-tier CGT can be avoided by owning business property outside the company, but this has disadvantages:
  - Entrepreneurs' relief will only be available on the property if its disposal is part of the owner's withdrawal from participation in the business, and relief will be restricted if the owner has received rent from the company.
  - The property would not qualify for 100% inheritance tax (IHT) business property relief.

### **Accumulating profits in a company**

In contrast to the problem of two-tier CGT, entrepreneurs' relief makes it potentially possible to achieve tax of only 28.9% on trading profits by using a company.

- The company pays corporation tax at 21% on profits retained in the company.
- On a liquidation of the company, the individual pays CGT on the retained profits at an effective rate of 10% after entrepreneurs' relief.
- For example, on £100,000 of retained profits the company pays corporation tax of £21,000. The individual then pays £7,900 CGT on the £79,000 of profits distributed in the course of a liquidation, an aggregate tax rate of 28.9%, compared to up to 50% if the individual had earned the profits as a sole trader.
- It is important that the accumulated profits retained are not so great that they endanger the company's trading status. This limits the scope of this tax planning strategy.
- There is also tax avoidance legislation that HMRC could use to attack this strategy in extreme cases.

### **Relief for trading losses**

Although the precise provisions vary, both individuals and companies can obtain relief for trading losses by:

- Setting them against any other income of the loss-making year.
- Setting them against any other income of the previous year.
  - A temporary extension to this relief allows **companies** to carry back some losses for up to three years, with later years' profits being relieved first.
  - The amount of losses that can be carried back to the immediately preceding year is unlimited. After carry-back to the immediately preceding year, up to £50,000 of any unused losses can be set against profits of the earlier two years.
  - This extended relief can be claimed by companies for losses of accounting periods ending between 24 November 2008 and 23 November 2010.
- Carrying them forward against future trading profits of the same business.

### **Starting trading**

- Individuals can set losses in the first four tax years of a new trade against total income of the three tax years before the year in which the loss arose.
- There is no equivalent corporation tax relief.

## Ending trading

- When companies cease trading, they can set any losses of the final 12 months of trading against trading income of the three previous years.
- Sole traders and partners can claim a similar relief on the cessation of trading, including a cessation caused by incorporation as a company.
- In some circumstances after incorporation, any unrelieved trading losses of a sole trader or partner may be carried forward against that person's future income (remuneration and dividends) from the company.

## Due dates for payment of tax

The dates on which tax is payable are different for individuals and companies, but overall the dates do not produce any significant cashflow difference.

## Self-employment

Income tax on business profits is payable on 31 January following the year of assessment. Payments on account are normally required on 31 January in the year of assessment and on the following 31 July.

Tax on chargeable gains is payable on 31 January following the year of assessment with no payments on account.

Depending on the choice of accounting date, the time between the end of the accounting year and the due date for the first instalment of tax could be anything up to nearly ten months.

## Incorporation

Corporation tax is payable in a single payment nine months after the end of the accounting year. Only the largest companies (profits of at least £1.5 million) have to pay corporation tax in quarterly instalments starting on the 14th day of the seventh month after the start of the accounting period.

- Tax on remuneration from a company is deducted at source under the PAYE system and paid monthly to HMRC together with NIC.
- No tax is due when dividends are paid, but any higher rate or additional rate income tax on dividends is paid on the normal self-assessment payment dates.

## Expenses and benefits

The 'benefits' of a sole trader or partner, such as private use of a business car, are normally taxed by way of a 'private use' adjustment, increasing taxable profits. Most benefits received by directors fall within the 'benefits in kind legislation'.

- Company cars are now heavily taxed. Sole traders and partners are generally in a more favourable position than company directors.
- Companies have to pay Class 1A NIC at 12.8% on the taxable value of virtually all benefits in kind, although there is no employee's NIC on benefits.
- A sole trader or partner only has to show that expenses are incurred wholly and exclusively for the purposes of the trade. A director who pays expenses personally must show that they were incurred wholly, exclusively and necessarily in the performance of the director's duties to obtain tax relief.

A company can provide its director with tax-free childcare vouchers worth up to £55 a week, subject to some conditions. Sole traders cannot qualify for this benefit.

## Employee participation

Share incentive plans and enterprise management incentives are fairly easy to set up and offer generous tax benefits for employees who hold shares or share options in their employing company. Although major shareholders cannot themselves participate in these schemes, they benefit indirectly through the greater motivation that employees have if they can participate in the company's profits. While sole traders and partnerships can enable employees to share in profits to some extent, any profit share paid to employees is fully taxable as remuneration.

## Close companies

Most small companies that are set up as an alternative to trading as a sole trader or partnership are classed as 'close' companies.

- A close company is a UK resident company in which five or fewer participators together control the company. A company is also close if it is controlled by any number of participators who are directors. The term participator includes anyone with a financial interest in the company, such as shareholders and debenture holders.
- The main tax disadvantage of a close company is that loans to participators (generally shareholders) result in the company having to pay tax of 25% on the amount of the loan. Such loans have to be declared in the company's corporation tax self-assessment. The tax is payable nine months after the year end.
  - This tax is repaid to the company nine months after the end of the accounting period in which the loan is repaid.
  - Short-term loans that are repaid before the tax on them becomes due do not give rise to tax.
- A close investment company is broadly a close company that is not a trading company or member of a trading group and also does not invest in property on a commercial basis. Such companies are charged at the full standard rate of 28% on all their profits. The purpose of this rule is to discourage individuals from holding investments in a company to benefit from lower corporation tax rates.

## Pension planning

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Both directors and self-employed people can invest in pension plans, but company pension schemes are a particularly tax-efficient way of remunerating employees and directors. Pension schemes have important tax privileges provided they are registered with HMRC:

- The contributions qualify for tax relief.
- The funds grow free of UK tax on both investment income and capital (but UK dividend tax credits cannot be reclaimed).
- At the selected retirement age, the plan can provide benefits in the form of a tax-free lump sum and a taxable income for the life of the policyholder and their spouse.

Pension considerations used to be an important factor in the decision on whether to incorporate. Major changes to the pensions regime that came into effect on 6 April 2006 (A Day) greatly increased the earnings-based amounts that can be paid into a pension plan for everyone except the highest earners. They also removed the differences between the various types of company and personal pensions that existed previously.

# Transfer of an existing business to a company

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## Procedure

If an existing business is converted into a private company, the procedure is as follows:

- The company is formed.
- The property of the existing business, possibly including an amount for goodwill, is transferred to the company at an agreed value.
- The company pays the seller by one or a combination of the following:
  - Issuing shares.
  - Taking over business liabilities.
  - Cash, which is often left outstanding on loan account.

## Stamp duty land tax and stamp duty

SDLT can be a significant cost on incorporation where a business owns a freehold or leasehold interest in land.

- SDLT is payable on the transfer of property to a company. SDLT is charged on the market value of the property. It is not possible to avoid duty by transferring property to a company for no consideration.
- The rates of SDLT on non-residential property are:

|  |     |
|--|-----|
| <b>Total value up to £150,000</b>        | Nil |
| <b>More than £150,000 up to £250,000</b> | 1%  |
| <b>More than £250,000 up to £500,000</b> | 3%  |
| <b>More than £500,000</b>                | 4%  |

- Stamp duty is payable at 0.5% on the consideration paid by the company for transfers of shares and securities.

## Capital gains tax

In principle, the transfer of assets such as property and goodwill is a disposal on which CGT arises. However, CGT reliefs normally mean that no tax is payable.

- The business (assets and liabilities) can be transferred wholly in exchange for an issue of shares. CGT is then in effect deferred until the shares are sold and the company takes over the assets at market value.
  - All the assets, with the optional exception of cash, must be transferred. If the business assets include property, SDLT will have to be paid on its market value.
  - The incorporation often results in a company with a very large share capital.
  - A transfer partly for shares and partly for cash will defer a proportion of the CGT.
- Alternatively, those assets that give rise to CGT could be transferred for cash at cost.

- The CGT can in effect be deferred until the disposal of the shares by claiming relief for gifts of business assets.
- The company can have a small share capital.
- The company takes over the assets at cost, so its taxable gain on a subsequent disposal will be larger than if it had acquired the assets at full market value.
- The pre-incorporation increase in value of the assets becomes tied up in the company.
- SDLT can be avoided by leaving property outside the company.
- Neither relief can wholly defer CGT on the transfer of an insolvent business with all its liabilities.
- Both reliefs enable an individual to receive cash from the company in an amount that produces a gain equal to the annual exemption, making it tax-free. For example, goodwill of a business that has been carried on for at least one year could be transferred for £18,180 in 2009/10, provided its value is at least this amount. After entrepreneurs' relief, which reduces the gain by 4/9ths, the individual would have a gain of £10,100 – the annual exemption. However, HMRC might contend that goodwill cannot exist independently, and therefore cannot be transferred at a value, where the business depends mainly on the personal skills and efforts of the proprietor.

## **Mortgages**

The owner of the business might want to transfer a property on which a mortgage exists into the company. It is important to check whether there are penalties or a different interest rate on renegotiation of the mortgage. If property with a mortgage is retained outside the company, the company may have to pay rent to enable the owner to pay mortgage interest and loan repayments. The owner will be liable to income tax on any excess of rent over the mortgage interest (but not loan repayments) and any other expenses of the property. Payment of rent would restrict entrepreneurs' relief if ever the company were sold in conjunction with the withdrawal of the owner from the business.

## **Cessation of trading**

One effect of the transfer of an unincorporated business to a company is that the transferor (the sole trader or partnership) will cease trading.

- Depending on the accounting date and the date of cessation, the final year's assessment can be based on up to two years' profits. For example, if a business has an accounting date of 30 April and is incorporated on 31 March 2010, the owner's assessment for 2009/10 will be based on profits from 1 May 2008 to 31 March 2010. Any overlap profits that arose when a business started (or arose in 1997/98 as a result of the transition to the current year basis of assessment) can be offset in the final year of assessment.
- If business profits have grown since the overlap profits arose, the overlap profits will not be enough to compensate fully for the long period of profits on which the final year of assessment is based. This could leave the transferor with an exceptionally large income tax liability.

## **Providing for the family**

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One advantage of forming a company is that interests in the business can be spread among members of the founder's family by a careful initial issue of shares, or by later gifts or other transfers of shares.

## Income tax

An individual might have a spouse who has little or no income and whose personal allowance and starting and basic rate tax bands are wholly or partly 'wasted'. It is generally easier for income to be diverted to such a spouse from a company than by a sole trader or partnership, although it has become more difficult for certain types of company businesses.

- A sole trader can only pay income to a spouse as salary. Such salary must be justified on commercial grounds by the work the spouse carries out, otherwise it will not be deductible against business profits.
- A spouse could enter into partnership and receive a share of profits. HMRC might not recognise such an arrangement where the spouse plays little or no part in the business. In addition, some professions require all partners to hold an appropriate qualification.
- A non-working spouse or other relative can hold shares in a company and receive due proportion of all dividends paid. However, dividends paid to minor children could be taxed as the parent's income.
- After losing a tax case in the House of Lords, the government promised to crack down on this sort of 'income shifting'. However, legislation has been postponed.
- Personal service companies cannot achieve a tax saving by paying salary or dividends to a spouse.

## Capital gains tax

Spreading shares among family members can reduce CGT on an eventual disposal of the shares through the use of each shareholder's annual CGT exemption. In addition, shares in an unlisted trading company can be transferred to other people without immediate tax liability using CGT 'gifts relief'.

To qualify for entrepreneurs' relief, shareholders in a trading company must hold at least 5% of the shares and voting rights and must be directors or employees.

## Inheritance tax

The business property relief of 100% means that most business assets are free of IHT.

- There is no guarantee that this generous relief will continue indefinitely.
- The corporate structure lends itself to greater flexibility in that it is possible to make gifts of small or large amounts of shares. This is far easier than transferring part of a partnership share.
- Business properties held outside the company benefit only from 50% business property relief where the owner has a controlling shareholding, and no relief otherwise. This drawback has to be set against the advantages of holding property outside the company, namely the avoidance of two-tier CGT, the avoidance of SDLT on transferring the property to the company and the ability to protect the property against trading liabilities.

## Limited liability partnerships

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Limited liability partnerships (LLPs) were designed mainly for larger professional partnerships. They combine the organisational flexibility of a partnership with the limited liability of a company.

- In a conventional partnership, partners have joint unlimited liability for business debts. This puts partners at risk of having to forfeit personal assets when a claim exceeds the partnership assets plus its insurance cover.
- The LLP is a separate legal entity that is liable for business debts up to the value of its assets. An individual partner could still have personal liability, but this is likely to occur only

where a partner has been negligent and had assumed personal responsibility for the advice. Normally it is possible to sue the LLP, not the individual partners.

- Although LLPs are most likely to be of interest to larger partnerships, any partnership of two or more people can register as an LLP by submitting an incorporation document to Companies House.
- The profits of an LLP are taxed largely in the same way as a conventional partnership.
- LLPs must lodge their accounts with Companies House. This allows anyone to check on the partnership's financial position. In contrast, such information about an ordinary partnership is only available to outsiders with the partners' permission.

## Tax planning key points

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When a company has been formed and is successful, it is both unusual and quite difficult to convert back to an unincorporated business without substantial tax problems (mainly CGT), so incorporation must be considered carefully.

- The main advantage of a company is limited liability, which can give considerable comfort in a climate of growing litigation.
- It is normally possible to save tax by incorporating a larger, more profitable business, especially if dividends can be used to avoid NIC.
- Other advantages of incorporation are the greater ability of a company to raise finance and the higher amount that can be paid into a pension scheme.
- The major disadvantage of incorporation is cost.

There is an administrative burden for the company itself and for the individuals who own and run it. These costs can be minimised and quantified by a well-organised business, and would appear to be good value where they secure limited liability and more flexibility for tax planning and raising finance.

*This guide is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking action on the basis of the contents of this publication. The guide represents our understanding of the law and HM Revenue & Customs practice as at August 2010, which are subject to change.*

Thank you for your interest in this Essential Guide. For further information or if you would like to discuss any aspect of the guide, please contact us.

Taxbriefs Limited  
Centaur Media plc  
St Giles House  
50 Poland Street  
London, W1F 7AX  
Tel: 020 7549 6726  
Fax: 020 7251 8867  
Email: [clientservices@taxbriefs.co.uk](mailto:clientservices@taxbriefs.co.uk)

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