

# **CLIENT MEMORANDUM**

## **SMALL BUSINESSES – SHOULD YOU INCORPORATE OR DISINCORPORATE?**

One of the most important questions when carrying on a business is whether it should operate as a sole trade, a partnership or a company. Once the decision has been taken, it is necessary to review the position regularly in the light of changes in legislation and the regulatory environment.

### **COMMERCIAL IMPLICATIONS**

It may be tempting to make the decision purely in relation to the taxation implications. It is true that these may be very important (and they are discussed later) but frequently the commercial considerations will be more important.

For some businesses, incorporation may not be possible as there are restrictions on the use of companies for carrying on certain types of professional work, such as barristers and the NHS practices of Doctors and Dentists.

One reason for favouring incorporation is that it enables you to operate with the benefit of limited liability. This can be especially important if the business is 'high-risk' or particularly prone to litigation claims. Examples are to be found in the building trade and certain consultancy businesses. A major claim from a customer/client could potentially bankrupt your business and you as proprietor. Of course if the business is carried on through the medium of a company the company could be forced into liquidation. However, unless you have given personal guarantees, or security, your own liability would normally be limited to the amount you have invested in the company.

Another important benefit from operating through a company is that it enables a share incentive scheme to be set up. A properly structured share scheme offers a method of incentivising key staff in a way which simply would not be possible in an unincorporated business.

Confidentiality is another important matter. A sole trader or a partnership is not required to publish a profit and loss account or balance sheet. However, limited companies over a certain size must file detailed financial information with the Registrar of Companies each year, and this information is available to the public, including of course your competitors.

In addition, there are a number of other ways of carrying on a business, apart from as a sole trader, a partnership or a limited company. For instance, an “unlimited company” may be used. Although an unlimited company still has to be registered at Companies House, it is not necessary to file the same level of detailed financial information as applies with many limited companies.

A further option has recently become available with the introduction of the limited liability partnership. This is a ‘cross’ between a partnership and a limited company, and offers the advantages of limited liability combined with a low level of public disclosure of financial information. Each partner in a limited liability partnership is liable to Income Tax on his (or her) share of the profits.

We will be happy to steer you through the various structures and advise which is the best approach in your particular circumstances.

## **TAX IMPLICATIONS**

Having considered the commercial background, it is also necessary to consider the tax implications of incorporation.

The top rate of personal Income Tax is currently 40%. In addition to this, a self-employed person (including a partner) must pay 8% National Insurance Contributions on profits between £5,035 and £33,540, plus 1% on all profits above £33,540.

The Chancellor introduced a nil rate of Corporation Tax on small profits with effect from 1.4.02, but this has now been withdrawn, because too many people were incorporating!

The rates of Corporation Tax from 1.4.06 are :-

Taxable profits	Up to £300,000	19%
Taxable profits	£300,001 to £1.5 million	32.75% (marginal rate)
Taxable profits	Above £1.5 million	30%

It is important to note that you cannot take additional advantage of the 19% rate by setting up a number of companies, e.g. by having (say) six companies each with a profit of around £60,000, instead of one company with a profit of £360,000. The tax rate is ‘pro-rated’ in these circumstances, so that no tax saving is achieved.

The way in which you extract profits from a company has an impact on the overall tax position. For example, if you draw a salary, this will be liable to income tax in your hands, and also to employers' and employees' national insurance contributions. However, the salary is tax-deductible for the company.

On the other hand, if you extract profits by way of dividend, there will be no national insurance contributions to pay, but the company does not obtain tax relief. The effective top rate of income tax on a dividend is 25%, whereas the top rate on salary is 40% (plus NICs!)

In addition, in the case of dividends, there is a risk of the Revenue using anti-avoidance legislation (see below).

We have mentioned the extraction of profits from a company by way of salary or dividends. A third way involves the liquidation of the company, and the withdrawal of surplus funds in the course of liquidation. Capital Gains Tax will normally be payable in these circumstances, but there are some generous CGT reliefs (annual exemption and taper relief) which may substantially reduce or eliminate the tax liability.

It should be noted that there is a potential "double Capital Gains Tax effect" when a company owns a property or certain other assets. If the company sells the asset it has to pay Corporation Tax on the gain, subject to the deduction of an indexation allowance for inflation. However, further tax is payable in respect of the same gain when the shareholder sells his (or her) shares in the company or when he (or she) receives a lump sum in respect of the shareholding on the winding up of the company. Although this liability may be alleviated (as mentioned above), the "double Capital Gains Tax effect" may be an unpleasant surprise for the unwary. In certain circumstances it may be beneficial to retain key assets outside a company (please see the Appendix for an example which illustrates this point).

### **NO SIMPLE ANSWERS!**

In very broad terms, the proprietor of an unincorporated business liable to tax at 40% needs to earn one-third more pre-tax profit to fund capital requirements (including loan repayments) out of income than a company liable at the 19% rate.

However, there are no 'rule-of-thumb' solutions. Careful analysis will be needed in each case to arrive at the right decision. It is also necessary to look at the long-term tax position in connection with the ownership of assets such as freehold property, long leases and goodwill. As mentioned earlier, the total tax ultimately payable on disposal of assets of this kind can be considerably greater where a company is the owner. Problems can also arise if you are considering the transfer of a business property into a new company. There are some potential tax pitfalls here, and the transfer will need to be carefully structured in order to optimise the tax position.

If you do decide to incorporate and your new company is a "personal service company", it may be caught by the legislation introduced in April 2000 which affects

this kind of company. In some cases, incorporation could be a futile exercise, since you may subsequently be held by the Revenue to be “employed” by your clients! The special rules attacking personal service companies now cover companies employing domestic workers.

If you transferred your business into a company in recent years, the position needs to be reviewed, and we shall be happy to do this, if you wish. In some cases, the Revenue are attacking the tax savings, using the anti-avoidance legislation relating to settlements. We can advise whether such an attack is likely in your own particular circumstances and – if so – whether it can be resisted. We can also advise whether it would be sensible to disincorporate, but it should be borne in mind that it may be costly in tax terms to do this; there are special reliefs on incorporation, but there are currently no reliefs on disincorporation.

If you are considering liquidating your company to return to self employed status, remember that goodwill is a capital asset which could be liable to Corporation Tax on capital gains on a winding up, even though it does not commonly feature as an asset in the Balance Sheet.

### **WHAT ABOUT GOODWILL?**

As already indicated, consideration should be given to the principal shareholder owning major assets and leasing them to the trading company if a corporate trading medium is desired.

Let us suppose that Fred has decided to set up in business and to operate via a limited company (“Newco”). It may be possible for him to license his business idea to Newco under a contract while retaining ownership of the goodwill. This is not common, but it is understood that it can be achieved in appropriate circumstances.

Legal advice would be essential prior to entering into an arrangement of this kind, but, if Fred in due course wishes to sell out, he will be able to sell both the shares and the rights to the goodwill to a purchaser. It should be noted that the goodwill would be fully chargeable to Inheritance Tax in the event of Fred’s death, and it may be appropriate to take out life assurance cover in this respect.

Sometimes, a business will buy a franchise from a franchisor. The capital expenditure will require careful analysis to determine the correct tax and accounting treatment. If goodwill is a substantial component of the purchase price, it should be borne in mind that tax relief may now be available if the goodwill is purchased and held in a company. This relief is available only to companies.

### **SEEK ADVICE**

It can be seen from the above that there are many different matters to look at when deciding how best to structure your business. (We have not considered VAT, Stamp Duty or Inheritance Tax, but these can be very significant).

Achieving a tax-efficient structure now could substantially reduce the amount ultimately payable to the Exchequer.

In addition, there are other issues to be considered in order to reach an informed decision. For example, the purchase of a new asset may well involve borrowings. We can assist you in your negotiations with lenders so that tax-efficient structures are not needlessly discounted in order to meet a lender's requirements.

Timely advice could make a significant difference in the long-term.

### **FOR GENERAL INFORMATION ONLY**

Please note that this Memorandum is not intended to give specific technical advice and it should not be construed as doing so. It is designed to alert clients to some of the issues. It is not intended to give exhaustive coverage of the topic.

Professional advice should always be sought before action is either taken or refrained from as a result of information contained herein.

## APPENDIX

### SCENARIO A

Stanley liquidates his trading company in the year 2010. Throughout the company's existence Stanley personally owned the trading premises which he let to the company at a market rent.

Stanley receives proceeds from the liquidation of the company which give rise to a capital gain on the realisation of the company's shares of £400,000. Stanley is liable to tax at 40%. Therefore, on this gain his tax liability is calculated as follows:

	£
Gain as assumed above	400,000
Less taper relief @ 75%	300,000
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	100,000
	<hr/>
Therefore, tax on realisation of shares at 40%	40,000
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Stanley also sells the trading premises, making a £1 million gain. His trading company occupied the premises throughout his ten year ownership. Stanley can claim that the capital gain arising on the business premises attracts the business asset rate of taper relief. Accordingly, Stanley's tax liability in respect of the trading premises as calculated as follows:

	£
Gain as assumed above	1,000,000
Less taper relief @ 75%	750,000
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	250,000
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Therefore, tax on property sale at 40%	100,000 (1)
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Stanley's total capital gains tax bill is therefore:	140,000
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Annual exemption has been ignored in the above calculations.

## SCENARIO B

The facts are as in Scenario A *except* that it is now assumed that Stanley decided originally to let the company purchase the business premises (which cost £600,000 in both scenarios). He still financed the purchase by lending an amount equal to the purchase price to the company, which remained outstanding until being repaid after the sale of the premises by the company in 2010. The impact of the growth in value of the trading premises falling inside the company, i.e. rather than immediately arising in Stanley's hands, can be demonstrated as follows:

	£	
Capital gain on premises realised by company	1,000,000	
Less indexation allowance, say, 35% of cost	210,000	
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	790,000	
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Tax payable by company:	237,000	(2)
Say tax rate in 2010 - 30%	<hr/>	
		£
Therefore, additional funds available to shareholders on liquidation, attributable to the growth in value of premises locked inside company, £1,000,000 less £237,000 i.e.	<hr/>	763,000
Therefore, additional capital gain arising to Stanley on realisation of shares:		
Additional proceeds	763,000	
Less 75% taper relief	572,250	
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Taxable	190,750	
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Tax payable by Stanley @ say 40%	76,300	(3)
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## COMPARISON

	£	
The tax payable in Scenario A on the gain on the property was only £100,000 (see item 1) whereas in Scenario B:		
The company pays	237,000	(2) above
Stanley pays	76,300	(3) above
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	313,300	
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The effective tax rate on the property gain is only 10% if Stanley owns the property throughout, whereas it is increased to 31.3% as a result of company ownership.

N.B. As indicated, other issues, such as inheritance tax and VAT must be considered.