

# Incorporation

The issue of whether to run your business as a company or a sole trader or partnership is an important decision. In this factsheet, we summarise the relevant tax changes which apply and show the potential tax savings currently available from operating as a company.

## Changes to the taxation of dividends

Significant changes to the taxation of dividends took place for dividends received from April 2016. Our calculations show that incorporation in 2016/17 and beyond may still result in lower tax bills than remaining unincorporated but the tax savings are significantly reduced from prior years.

## The new rules for the taxation of dividends

From 6 April 2016:

- The 10% dividend tax credit has been abolished with the result that the cash dividend received is the gross amount potentially subject to tax.
- New rates of tax on dividend income will be 7.5% for basic rate taxpayers, 32.5% for higher rate taxpayers and 38.1% for additional rate taxpayers.
- A new Dividend Tax Allowance will remove the first £5,000 of dividends received in a tax year from taxation.

The table below shows a comparison between the pre and post 6 April 2016 tax rates.

<b>Dividend falls into:</b>	<b>Basic rate band</b>	<b>Higher rate band</b>	<b>Additional rate band</b>
Effective rate before 6 April 2016	0%	25%	30.6%
Rate from 6 April 2016	7.5%	32.5%	38.1%

There are winners and losers from the changes to taxation of dividends.

## Winners

An example of a winner is a higher rate taxpayer who has dividend income of £5,000. Under the previous rules they had a tax liability of £1,250 (25% of £5,000). From April 2016 they will have no tax liability.

## Losers

An example of a loser under the regime will be the sole shareholder of a company who takes a small salary and then dividends up to the threshold at which higher rate tax is payable. Under the previous rules

they have no income tax on the salary (as the salary is below the personal allowance) and no tax on the dividend. From April 2016, only £5,000 of the dividend will not be taxable.

## Is trading as a limited company still be the best option?

If you trade as a limited company you may think that to trade as a sole trader or as a partnership may now be a better option from April 2016. In our view there is still a benefit in tax terms for most individuals to continue to trade as a limited company. The tax saved by incorporation compared to being unincorporated is lower for 2016/17 than for 2015/16 but there is still an annual tax saving.

## Will it be better to take a dividend rather than an increase in salary?

In our view there is still a benefit for a director-shareholder to take a dividend rather than a salary. The amount of the tax saved will be less than under the previous rules but is still beneficial.

## Tax savings

The examples below give an indication of the 2016/17 tax savings that may be achievable for husband and wife who are currently in partnership.

<b>Profits:</b>	<b>£30,000</b>	<b>£50,000</b>	<b>£100,000</b>
<b>Tax and NI payable:</b>	<b>£</b>	<b>£</b>	<b>£</b>
As partners	3,142	8,942	25,262
As company	2,776	7,618	20,618
Potential saving	366	1,324	4,644

The extent of the savings is dependent on the precise circumstances of the couple's tax position and may be more or less than the above figures. The examples are computed on the basis that the couple:

- share profits equally
- have no other sources of income
- both partners take a salary of £8,060 from the company with the balance (after corporation tax) paid out as a dividend.

## **When might a company be considered?**

A company can be used as a vehicle for:

- a profitable trade
- buy-to-let properties.

## **Summary of relevant tax and national insurance rates**

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### **Rate of corporation tax**

Profits are taxed at 20%.

### **National Insurance**

The rate of employees' NIC is 12%. In addition, a 2% charge applies to all earnings over the NIC upper earnings limit (£43,000 for 2016/17). The rate of NIC for the self-employed is 9%, and 2% on profits above £43,000 for 2016/17.

All NI contributions can be avoided by incorporating, taking a small salary up to the threshold at which NI is payable and then taking the balance of post-tax profits as dividends.

### **Pension provision**

As an employee/ director of the company, it should be possible for the company to make pension contributions (subject to limits) to a registered fund irrespective of the salary level, provided it is justifiable under the wholly and exclusively rule. For further details of the tax position of pension provision for individuals see the factsheet on Pensions - Tax Reliefs. Such contributions are deemed to be a private expense for sole traders or partners.

### **Other tax issues**

In addition we consider other relevant factors including potential disadvantages. It is all too easy to focus exclusively on the potential annual tax savings available by operating as a company. However, other tax issues can be equally, and in some cases more significant and should not be underestimated.

### **Capital gains**

Incorporating your existing business will involve transferring at least some of your assets (most significantly goodwill) from your sole trade or partnership into your new company. The transfer of goodwill may create a significant capital gain although there is a mechanism for deferring the gain until any later sale of the company if the business is transferred in exchange for shares in the company.

## Changes to relief for goodwill

Generally where goodwill was sold to the company for cash or debt on or after 3 December 2014, individuals are prevented from claiming Entrepreneurs' Relief (ER) and capital gains tax arises on the gain. The exceptions to this rule are that a claim to ER is allowed:

- for partners in a firm who do not hold or acquire any stake in the successor company
- where the individual claiming relief holds less than 5% of the shares and the voting power of the acquiring company
- where an individual holds 5% or more of the shares or voting power if the transfer of the business to the company is part of arrangements for the company to be sold to a new, independent owner.

## Stamp Duty Land Tax (SDLT)

There may be SDLT charges to consider when assets are transferred to a company. Goodwill and debtors do not give rise to a charge, but land and buildings may do so.

## Income tax

The precise effects of ceasing business in an unincorporated form, including 'overlap relief' need to be considered.

## Capital allowances

Once again the position needs to be carefully considered.

## Other advantages

There may be other non-tax advantages of incorporation and these are summarised below.

### Limited liability

A company normally provides limited liability. If a shareholder's shares are fully paid he cannot normally be required to invest any more in the company. However, banks often require personal guarantees from the directors for borrowings. The advantage of limited liability will generally apply in respect of liabilities to other creditors.

### Legal continuity

A company will enjoy legal continuity as it is a legal entity in its own right, separate from its owners (the shareholders). It can own property, sue and be sued.

### Transfer of ownership

Effective ownership of the business may be more readily transferred, in comparison to a business which is not trading as a limited company.

### Borrowing

Normally a bank is able to take extra security by means of a 'floating charge' over the assets of the company and this will increase the extent to which monies may be borrowed against the assets of the business.

## **Credibility**

The existence of corporate status is sometimes deemed to add to the credibility or commercial respectability of the business.

## **Pension schemes**

The company could establish an approved pension scheme which may provide greater benefits than self-employed schemes.

## **Staff incentives**

Employees may, with adequate safeguards, be offered an opportunity to acquire an interest in the business, reflecting their position in the company.

## **Disadvantages**

No analysis of the position would be complete without highlighting potential disadvantages.

## **Administration**

The annual compliance requirements for a company in terms of administration and accounting tend to result in costs being higher for a company than for a sole trader or partnership. Annual accounts need to be prepared in a format dictated by the Companies Act and, in certain circumstances, the accounts need to be audited by a registered auditor.

Details of the directors and shareholders are filed on the public register held by the Registrar of Companies.

## **Privacy**

The annual accounts have to be made available on public record - although these can be modified to minimise the information disclosed.

## **PAYE/Benefits**

If you do not have any employees at present, you do not have to be concerned with PAYE and returns of benefits forms (P11Ds). As a company, you will need to complete PAYE records for salary payments and submit details of salary payments on a timely basis under PAYE Real Time Information. You will also need to keep records of expenses reimbursed to you by the company. Forms P11D may have to be completed.

## **Dividends**

If you will require regular payments from your company, we will need to set up a system for you to correctly pay dividends.

## **Transactions with the business owner**

A business owner may introduce funds to and withdraw funds from an unincorporated business without tax implications. When a company is involved there may be tax implications on these transactions.

## **Director's responsibilities**

A company director may be at risk of criminal or civil penalty proceedings eg for late filing of accounts or for breaking the insolvency rules.

## How we can help

There may be a number of good reasons for considering use of a company as part of a tax planning strategy. However as you can see from this factsheet, there are many factors to consider and proposed changes to the tax law may change this advice for some individuals. We would welcome the opportunity to talk to you about your own specific circumstances. Please do not hesitate to contact us.

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