Incorporation

The issue of whether to run your business as a company or a sole trade 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.

Caution - changes in tax law ahead

This factsheet calculates the position for 2015/16, however please be aware that significant changes are proposed to the taxation of dividends which were announced in the Summer Budget. These changes do not affect the current tax year but clearly will impact on a decision to incorporate.

Our initial 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. Please note that we only have draft legislation at present as the new regime will be legislated for in Finance Bill 2016. The changes will affect dividend receipts from 6 April 2016. Individuals who extract profits from their company as dividends may need to consider whether to increase dividend payments before this date.

The new rules for the taxation of dividends

When a dividend is paid to an individual, it is subject to different tax rates compared to other income due to a 10% notional tax credit being added to the dividend. So for an individual who has dividend income which falls into the basic rate band the effective tax rate is nil as the 10% tax credit covers the 10% tax liability. For a higher rate (40%) taxpayer, the effective tax rate on a dividend receipt is 25%.

From 6 April 2016:

- The 10% dividend tax credit is abolished with the result that the cash dividend received will be 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 current and prospective tax rates.

<table>
<thead>
<tr>
<th>Dividend falls into:</th>
<th>Basic rate band</th>
<th>Higher rate band</th>
<th>Additional rate band</th>
</tr>
</thead>
<tbody>
<tr>
<td>Effective dividend tax rate now</td>
<td>0%</td>
<td>25%</td>
<td>30.6%</td>
</tr>
<tr>
<td>Rate from 6 April 2016</td>
<td>7.5%</td>
<td>32.5%</td>
<td>38.1%</td>
</tr>
</tbody>
</table>

There are winners and losers from the new regime.

An example of a winner is a higher rate taxpayer who has dividend income of £5,000. In the current tax year he will have a tax liability of £1,250 (25% of £5,000). Next year he will have no tax liability.

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. In the current tax year he has no income tax on the salary (as the salary is below the personal allowance) and no tax on the dividend. Next year only £5,000 of the dividend will not be taxable.

Will trading as a limited company still be the best option?

If you are currently trading as a limited company you may think that to trade as a sole trader or as a partnership may be a better option for you after 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 will be reduced next year 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 current regime.
Should dividends be paid before 6 April 2016?

If you do not currently extract all the company profits as a dividend you may wish to consider increasing dividends before the 6 April 2016. However, other tax issues may come into play, for example the loss of the personal tax allowance if your total 'adjusted net income' exceeds £100,000. There will also be non-tax issues such as the availability of funds or profits in the company to pay the dividend.

Please contact us before you make any decisions about changing the amount of dividends taken.

**Tax savings**

The examples below give an indication of the 2015/16 tax savings that may be achievable for husband and wife who are currently in partnership.

<table>
<thead>
<tr>
<th>Profits:</th>
<th>£30,000</th>
<th>£50,000</th>
<th>£100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax and NI payable:</td>
<td>£</td>
<td>£</td>
<td>£</td>
</tr>
<tr>
<td>As partners</td>
<td>3,302</td>
<td>9,102</td>
<td>25,580</td>
</tr>
<tr>
<td>As company</td>
<td>2,776</td>
<td>6,776</td>
<td>18,106</td>
</tr>
<tr>
<td>Potential saving</td>
<td>526</td>
<td>2,326</td>
<td>7,474</td>
</tr>
</tbody>
</table>

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.

**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.

Where goodwill is sold to the company for cash or debt on or after 3 December 2014, individuals are prevented from claiming Entrepreneurs’ Relief (ER). Capital gains tax will be payable on the gain at the normal rates of 18% or 28% rather than 10%. The exception to this rule is that a claim to ER is allowed for partners in a firm who do not hold or acquire any stake in the successor company.

We will need to discuss in detail with you the most appropriate mechanism for your business.
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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