INCORPORATION – A TAX SUMMARY

Why incorporate?

Many businesses commence in an unincorporated form as a sole trade or a partnership. Start-ups benefit from the simplicity and low administration provided by a sole trader structure in particular. Relief for opening years' losses are also significantly more favourable for sole traders and new partners. Even once a business has become established, operating in an unincorporated form has benefits and may continue to suit the owners indefinitely.

However, there is a distinct path for growing businesses whereby incorporation becomes a natural step. The key reasons to incorporate are:

- limited liability allowing the mitigation of risks associated with expansion
- tax mitigation
- flexibility over income in respect of the timing and form of remuneration
- a reduced perception of the administrative burden due to familiarity with running a business
- a greater ease of attracting external investment
- prestige value
- certain tax reliefs are only available to companies eg research and development enhanced tax relief

The weight given to each of the key reasons for incorporation depends on the business and its owners. However, a lower headline rate of tax is an incentive to run a business through a limited company. On a simple comparison, the difference on tax rates for retained profits between companies and unincorporated businesses may look large but an assessment needs to be made of any further tax on extracting profits from the company.

The tax implications of incorporating

Income tax

The unincorporated business will cease, and this could have an impact on the level of profits assessed in the final tax periods depending on the date of cessation and if there are any tax losses in the business. We would be able to provide you with a full summary of the expected taxable income which will arise on cessation.

Any plant and machinery used by the business will usually be transferred to the company at the market value of the items. This could give rise to additional taxable amounts or tax deductions depending on the difference between the market value and the tax value of the assets. It may be better to elect to transfer the assets at their tax values which would then mean the transfer of assets is tax neutral. Similar rules apply to the transfer of stock in the business.

The business owner will become a director of the company and so becomes liable to tax on benefits in kind in respect of private use of business assets. As an unincorporated business the private element of these costs are not allowed as a deduction from profit.

Capital gains tax

Any assets which are subject to capital gains tax, for example land and buildings or goodwill, will be treated as being transferred to the company at market value and so normally would generate a capital gain. There are two available reliefs which can be claimed to defer a tax charge arising on incorporation, these are incorporation relief and gift relief although business asset disposal relief should also be considered.

Each of these two incorporation reliefs has qualifying conditions and which one is appropriate will depend on what assets are being transferred into the business. An alternative to both incorporation relief and gift relief is to transfer the business assets at market value and suffer the capital gains tax whilst the tax rates on capital gains are relatively low compared to income tax rates. This could also provide a loan account balance for the director to draw down effectively tax-free, thus minimising the income extracted and related income tax liabilities in the early years of the business.

NIC and VAT

When a sole trader transfers their business to a company, they will be changing their status for NIC purposes and the company will be required to pay secondary Class 1 NIC. In the year of incorporation, it may be necessary to consider NIC annual maxima rules.

The transfer of the business is likely to be treated as a transfer of going concern for VAT purposes if the business is VAT registered.

Stamp duty land tax (SDLT)

SDLT is a key factor for businesses with valuable property. SDLT is charged on the market value of the property transferred at rates dependent on the value (even where there is no cash consideration).

An option may be to retain the property outside the company and receive market rent from the company for use of the property in its trade.

Inheritance tax (IHT)

Depending on the structure of the incorporation, consideration should be given to the impact of incorporation on business property relief.

Extracting profit post incorporation

There are various methods which can be used to extract profit from the company after incorporation. In summary these are as follows:

- salary
- dividends
- rent on any property used by the company for the business which is held personally
- interest on a director's loan account if this was set up when the company was incorporated
- pension contributions
- other benefits in kind

Usually, a combination of these methods will be used and may be flexed each year depending on the business owner's situation and needs.

In addition, where family members are involved in the business care is needed to ensure that any form of remuneration is tax efficient and also deductible against the profits of the company.

One area to be aware of on incorporation is that there are tax charges on loans from companies to the owners of the business where they are greater than £15,000. A loan will give rise to a tax charge on the company at dividend higher rate on the amount of the loan which has not been repaid within nine months of the company's year-end. The tax is repayable on the repayment or release of the loan. The repayment is due to the company nine months after the end of the period in which the loan is repaid / released and so there may therefore be a significant delay in securing the repayment. Loans to shareholders and directors must therefore be carefully monitored.

Further information

If you are thinking of incorporating your business, please get in touch on 01435 898180 to discuss all the above areas in relation to your business.