



Incorporation - Accounting and Tax Issues

The choice of business vehicle, be it sole trader, partnership or limited company, will depend on a wide number of legal and commercial factors. Any decision to incorporate must only be made after careful consideration and this Help Sheet, whilst not exhaustive, sets out some of the key issues that might influence a decision. Advice specific to the business' individual circumstances should be sought.

Tax Charges on Retained Profits

Sole traders and partnerships are often disadvantaged where there are high profit levels and proprietors do not wish to extract the full amount for personal use. This is because they are taxed on profits irrespective of whether drawn, potentially at 40% or even 50%. However, small companies (up to £300,000 of taxable profit) are taxed at just 20% (unless there are associated companies).

With a company there is the flexibility to take funds through salaries or dividends or to leave profits in the company. If salary is taken this is a tax-deductible expense for corporation tax but will attract personal tax and National Insurance for the proprietor under the PAYE scheme.

Dividends are taken after corporation tax but do not attract National Insurance. For individuals receiving the dividends they are tax free for a basic rate taxpayer, while for a higher rate taxpayer they bear an effective rate of 25% or 36.1% for additional rate taxpayers.

The most efficient way to withdraw value from the company will depend on how the funds are extracted, dividend or salary, the proprietors' level of other income and the facts of the individual case. This and whether incorporation can present tax savings, is something Monahans can advise you on.



Capital Gains



One frequently cited disadvantage of incorporation is a potential double tax charge on cessation or disposal of the business.

However Entrepreneurs' Relief reduces the rate of Capital Gains Tax from 28% (for an individual whose income and gains exceed £35,000) down to 10% in respect of the first £5 million of gains arising on the disposal of a business, part of a business, shares in a trading company and

associated disposals such as the property from where the business was run. The qualifying criteria of Entrepreneurs Relief are more strict in respect of a disposal of shares as a minimum shareholding and voting rights of 5%, in a trading company in which the shareholder works, held for twelve months is required to qualify for the lower 10% tax rate

It is important to take advice and to plan carefully for the disposal of the business whether it is incorporated or not. Further guidance is given in our Help Sheet "Selling your Business".

Tax Cash Flows

Unincorporated profits are taxed under self-assessment with bi-annual payments on account and a settlement payment. Dividends taken would be taxed under this regime but salaries are taxed by deduction under PAYE as paid. Corporation tax for smaller companies is payable nine months after the period end in which it accrues. The changes in due dates for payments will have cash flow implications.



Limited Liability

A company is a separate legal entity and as such shareholders are only liable to the amount unpaid on their shares. This is in reality reduced by the requirement by many banks, and other institutions, to require shareholders and directors to give personal guarantees over debts. Any action against the business, not specifically covered by a personal guarantee, however, would still be taken against the company and the shareholders would be protected. This is particularly significant in certain sectors where the risk of legal action is greater.

Access to Finance



Banks may prefer to lend to incorporated entities. This is not a wholly conclusive argument but is supported by the banks ability to have a floating charge over the book asset of a company. This is not possible for an unincorporated business and the extra security can be very attractive.

Transferability of Shares

The nature of shares is such that they can be transferred a lot more easily than a holding in an unincorporated business. This has a number of implications. It aids succession planning as shares can be gifted on a piecemeal basis. This allows partial dilution of control or ownership to suit tax, commercial, or other considerations.

Flexibility of Profit Sharing

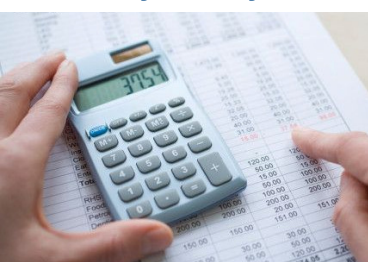
Where there is a partnership there is flexibility over how profits are shared between the partners, regardless of actual involvement in the business. With a limited company remuneration must be justifiable by participation. There is the option for payment of dividends but all shares in any class will attract the same dividend, restricting flexibility. To enable flexibility separate classes of shares can be set up.

See the help sheet Settlement Legislation - Arctic Systems and Income shifting.

While the government has put the introduction of "income shifting" on a back burner, a commitment to revisit the subject in the future remains.



Flexibility to Pay Children and Aid Tax Planning



Share ownership can be structured to optimise tax planning opportunities. This can include gifting shares to children and paying a dividend. Children within the basic rate tax band will not incur any additional income tax. This can be very tax efficient and particularly useful where children have no income such as students.

The children must not be minors however.

Is This too Good to be True?

In exchange for limited liability a company must be run within a more defined regime than an unincorporated business. There are specific procedures for many things and a range of forms that have to be submitted to Companies House.

The accounts must be prepared in accordance with much more stringent accounting standards including a wide range of disclosure notes, these are quite onerous. Accounts must be filed at Companies House and are available to the public, reducing confidentiality.

If the company exceeds the audit requirements, then it is legally required to have the accounts audited.

The tax treatment of private use company cars can be expensive so you should check this with your normal contact at Monahans



Legal Duties

As directors and company secretaries there will be a number of legal obligations imposed. It is the directors' duty to act in the interests of the company but there are provisions in place to protect other parties.

An example of this is the rules governing unlawful trading, a criminal offence.

Withdrawal of Funds from the Company



As a company is a separate entity so it follows that its funds are not those of its owner. Company funds must only be taken out through formal channels, either a salary, which must go through the PAYE scheme and have tax and National Insurance deducted accordingly or through dividends taxed under self assessment. Dividends must be formally declared and minuted and the company must issue tax certificates.

This is a complicated area which is covered in greater depth by our Help Sheet "Tax Efficient Remuneration".

Loss Relief

Losses incurred in a company can only be offset against profit of that company, usually in the future. Losses of an unincorporated business can be offset against other personal income. If the business is commencing and early losses are anticipated unincorporated businesses have the advantage of being able to carry back the losses against other income in earlier years. Companies have to wait until sufficient profits are made in the future to utilise them.

Actual Process of Incorporation

There will be administration in setting up a company, its directors and shareholders. The company will need a separate VAT registration and PAYE scheme. There will need to be new stationery, bank accounts, etc etc.

Customers and suppliers will need to be informed of the new details. There will need to be assignment of things to the company for example leases, supply contracts, employee contracts. This is explored in more detail in our Help Sheet "Legal Issues of Setting Up a Limited Company".



For further advice and assistance

Monahans can assist you in determining the implications of incorporation for you and your business.

Please call your normal contact at Monahans for further information or help on this matter.