Corporate and business tax
Incorporation

The issue of whether to run your business as a company or a sole trade or partnership is an important decision. In tax terms, due to the cumulative effect of changes to the tax system over the last five years, there can be significant tax savings if a business is incorporated.

In this factsheet, we summarise the relevant tax changes and show the potential tax savings available from operating as a company. In addition we consider other relevant factors including potential disadvantages.

Tax Savings

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

Profits:	£30,000	£50,000	£100,000
Tax and NI payable:	£	£	£
As partners	5,882	11,882	29,312
As company	3,648	7,612	21,395
Potential saving	2,234	4,270	7,917

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 £4,745 from the company with the balance (after corporation tax) paid out as a dividend.

Remember that the tax savings indicated are based on current tax legislation. It is possible that the legislation may be changed so that incorporation is no longer beneficial.

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 Changes to the Tax System

Rate of corporation tax for small companies

The corporation tax starting rate was reduced from 10% to 0% with effect from 1 April 2002. Profits between £10,000 and £50,000 benefit from marginal relief, whilst profits between £50,000 and £300,000 are taxed at 19%.

The small companies corporation tax rate in 1996/97 was 24%. Since that time the basic rate of income tax has fallen from 24% to 22%, with only a relatively small amount being taxed at the 10% starting rate.

However, the benefit of corporation tax rates below 19% where profits are below £50,000 is now only available where profits are retained within the company. A new regime imposes a minimum 19% corporation tax rate where profits are taken out of the company as a dividend.

Advance corporation tax

The abolition of advance corporation tax on dividends has improved the position in favour of the basic rate shareholder taking dividends rather than being self-employed and taxed on the profits directly.

National Insurance

Increases in NI for employers, employees and the self-employed have added to the incentive to avoid these charges.

The rate of employees' NIC is 11%. In addition, a 1% charge applies to all earnings over the NIC upper earnings limit (which is £31,720). The rate of NIC for the self-employed is 8% on profits above £31,720.

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.

Stakeholder pensions

Finally, the new regulations for stakeholder pensions mean that it is necessary only to take a salary one year in six. Pension payments in each of the six years can be based on the salary paid in the one year. A new pensions regime will be introduced in April 2006. However it will still be possible for a company to make significant pension contributions for a director/shareholder irrespective of the salary level.

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Other Tax Issues

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. This can create significant capital gains although there are mechanisms for deferring these gains until any later sale of the company. We will need to discuss in detail with you the most appropriate mechanism for your business.

Do you want to transfer all of your business assets to the company? It may be appropriate to retain personally a valuable property particularly if there is likely future capital appreciation.

Be aware that it may be possible to extract some tax-free proceeds from the company by transferring assets in a particular way. Typically the tax-free sum is currently at least £30,000.

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.

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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 with 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 keep records of expenses reimbursed to you by the company and 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 currently 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. We would welcome the opportunity to talk to you about your own specific circumstances.