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Incorporating your own business - tax implications

Overview: Traders may wish to incorporate their business for a variety of reasons, such as the protection of limited liability, but should be aware of taxation implications. There are tax advantages in forming a company, but one should also be mindful of some disadvantages and as circumstances of individual traders vary it is advisable to look carefully at each case. An example is start-up losses which can have advantages for the unincorporated trader and it may be beneficial to trade as an unincorporated business in early years (provided that limited liability or other factors are not required) and incorporate later. These points are outlined below.

One reads press reports comparing the small business rate of corporation tax (CT) of 20%, against the higher and additional rates of personal tax ranging from 40% to 50% payable on profits by a sole trader or partnership whether money is drawn or left in the business. What is often missed is that the unincorporated trader's money is his or hers to spend after taxation whereas company money is still inside the company after taxation, although the proprietor of a company can decide how much to draw either by wages or dividends or to leave in the company, in which rates of personal tax might be a planning factor.

A company is a separate legal entity from the proprietors – the shareholders – and is taxed separately to CT. The shareholder may receive a share of the profits in the form of dividends. Earnings of directors and employees are taxed by the company under PAYE for which the company must account as well as both employer and employee national insurance contributions (NIC), although the company would have been entitled to a corresponding deduction for director's wages and employer's NIC in calculating profit for CT. Withdrawing money through dividends is an attractive option because no NIC is payable and there is no extra tax to pay for basic rate taxpayers, although CT would have been paid, as dividends do not count as deductions in calculating profits, being distributions of profits. In addition many directors have a current account or loan account with the company. The company is responsible for tax on any overdrawn loan account.

Unincorporated trader

The unincorporated trader is taxed at the rate of income tax and NIC appropriate to his or her on business profits. Similar principles would apply to members of a partnership on their share of the profit. In addition to income tax a trader below retirement age is required to pay class 2 NIC of £138 per annum (unless obtaining exemption for small profits (£5,595 for 2012/13) and class 4 NIC at 9% between profits of £7,605 and £42,475 and 2% above that upper profit limit. Above the 2012/13 personal allowance of £8,105, one would pay a combined tax and NIC of 29%. Above £42,475 (the higher rate tax band plus the personal allowance), the combined rate becomes 42%, and for profits above £150,000 the rate becomes 52% for 2012/13. An unincorporated business pays tax by half yearly instalments on 31 January and 31 July. Cash flow comparisons may be made with monthly PAYE obligations of a company.

Capital gains tax is payable on chargeable gains of the unincorporated trader, while gains of a company feature in the computation of CT.

Start-up losses

These deserve serious consideration for the start up trader who anticipates making losses in early years of trading, maybe due to expenditure on equipment on which capital allowances are claimable. Unincorporated traders may claim for losses in any of the first four years to be carried back to set against any income, including employment, of the previous three tax years. Apart from the special rules in these earlier years, a loss may be set off against any other income of the same year or the previous year. Losses not used in this way are carried forward to set off against profits of the same trade in future years.

Incorporating from a sole trade or partnership

When the business of the sole trader or partnership is being transferred to a company, a separate legal entity, the cessation provisions will normally apply to the business and consideration would need to be given to any capital gains tax arising on transfer of business assets, such as buildings and goodwill, to the limited company, capital assets being treated as having been disposed of at their market value. Much of this can be avoided by use of various elections and reliefs described below.

Continuity elections enable avoidance of the following cessation computations.
Capital Allowances: Tax rules normally involves a deemed disposal involving a balancing charge or allowance on equipment and machinery. This can be avoided by an election by both transferor and company for the company to take over these assets for tax purposes at their written down value, as if there was a continuous trade. The time for election is two years.

As regards **trading stock**, the parties may jointly elect for the higher of cost to the unincorporated trader or price paid by the company to apply instead of market value, if both of these are lower than the market value. The time limit for the election is one year from 31 January after the end of the tax year in which the transfer is made. Where **VAT** is payable, it is important to be aware of the compulsory VAT rules on the transfer of a business to a company as a going concern, the company usually taking over transferor's VAT position. (Vat notice 700/9 explains the procedure more fully and may be essential reading).

While unused **trading losses** cannot be carried forward directly against company profits, there are the following reliefs to enable the trader to use pre-incorporation losses:

- set off against any other income of the same year or the previous year
- a loss in the last 12 months may be set off against trading income for the 3 previous years
- set off against income derived from the company provided that the business was transferred solely or mainly in exchange for the allotment of shares. Income derived from the company includes directors' remuneration, dividends, interest or rent received from the company.

Capital Gains Tax may arise if there has been an increase in the value of capital assets, such as the business premises, and if goodwill is a feature. In these circumstances it may be wise to take professional advice on capital gains before the transfer is legally structured, as there are a number of issues and several reliefs (outlined below) worth considering but also the interaction of these reliefs.

Roll-over relief (S162 of Taxation of Chargeable Gains Act 1992) (referred to in HMRC help sheet HS276 as Incorporation relief) enables some or all of the gain to be deferred until such time as the shares are disposed of, if the business was transferred as a going concern wholly or partly in exchange for shares and in planning it may be worthwhile to incur sufficient liability to be offset by the CGT annual exempt amount, for example by receiving part of the consideration in cash. On the eventual disposal of the shares, if held for more than 1 year, entrepreneurs' relief may be available. S162 relief is given automatically provided the various requirements are met but the trader may elect for s162 not to apply.

Gifts of business assets (S 165 TCGA) enable the transferor and the company to claim to defer any capital gain until the company sells the gifted asset. Assets are gifted if transferred at less than market value, so some money may be received on which CGT is reduced by annual relief and S165 apply to the balance.

Entrepreneurs' relief at 10% rate of CGT may be available, on transfer in preference to tying up money in shares especially where cash flow to the trader is a consideration.

CGT and stamp duty land tax may be avoided by retaining the business premises personally instead of transferring these to the company. Rent may be charged to the company for business use.

Company Tax

The small CT rate (on profits below £300,001) is 20% payable 9 months after the end of the accounting period. Above £1.5m, the CT rate is 24%, with marginal relief due for profits within the above limits. Remuneration is an allowable deduction against profits but is subject to PAYE. There is also class 1 NIC (both on director and the company rate of 13.8%), except where money is taken via a dividend. CT trading losses are allowable against total profits of the current accounting year, then if appropriate against total profits of the previous year, with any balance being carried forward against future trading profits. The tax rules on business expenses incurred by the director are considerably tighter than business expenses claimed by an unincorporated trader.

Serious consideration should be given to payment of NIC, for example failure for an individual to have paid or to have been credited with annual contributions of at least the lower earnings level may well affect full basic state pension rights. Consideration should also be given to company or private pension contributions.

Dividend
Dividends paid are not a deduction in calculating profits. Income tax on dividends depend on the rate of individual's tax band after other income against which the shareholder receives a tax credit of 10%, so effectively there is no additional tax to pay for the basic rate payer, as follows:

Basic rate	10%	effective extra tax after tax credit	nil
Higher rate	32.5%	" " " " " "	25%
Additional rate	42.5%	" " " " " "	36.1%

Comparisons
While comparisons can cover limitless situations, we may look at a situation where in 2012/13 both a sole trader and a company each make profits of £50,000, but the director withdraws £40,000. In **example 1** below, the director takes a salary of £40,000 but with the addition of employer's NIC this cost the company £44,487, and after tax and NIC the director is left with £29,734 to draw and £4,410 left in the company on which CT has been paid, but if he wishes to draw this via a bonus his company will have to consider further PAYE. The sole trader has available £36,689 after tax and NIC which he is free to spend or save. **Example 2** looks at a situation where the director takes remuneration of £10,000 on which tax and NIC amounts to £666 and £30,000 dividend. There is no NIC on the dividend but the company pays CT of £7,931. He draws £39,334 with £1,722 left in the company.

Example 1
Business profits before tax and NIC are £50,000. The director is paid a salary of £40,000 in 2012/13. The comparative position is:

		Sole trader		**Company director**
Profits/ salary		50,000		40,000
Personal allowance		8,105		8,105
Taxable income		41,895		31,895
Taxable @ 20%	on 34,370	6,874	on 31,895	6,379
@ 40%	on 7,525	3,010		
	41,895	9,884		6,379
Class 1 NIC (employee) @ 12% on 32,395			(40,000-7605)	3,887
Class 2 NIC		138		
Class 4 NIC @ 9% on 34870 (42,475-7605)		3,138		
@ 2% on 7525 (50,000-42475)		151		
Total personal tax & NIC		13,311		10,266

Company's tax & NIC		Company profit £ 50,000	
Less director's salary		(40,000)	
Company's NIC 13.8% on 32512 (40,000-7488)		(4,487)	4,487
CT @ 20% on 5513 (company profit after deduction of salary)			1,103
Total Tax & NIC	13,311		15,856

Example 2

Sole trader, as above	Company director
Remuneration	10,000
Personal allowance	8,105
Taxable income	1,895
Taxable @ 20% on 1895	379

Class 1 NIC (employee) @ 12% on 2,395	(10,000-7,605)		287
Dividend £30,000: covered by tax credit (see note)			0
Total personal tax & NIC			666

Company's tax & NIC	Company profit £ 50,000		
Less director's salary		(10,000)	
Company's NIC 13.8% on 2512 (10,000 – 7488)		(347)	347
Tax @ 20% on £39,653 (company profit for CT)		39,653	7931
Overall Tax & NIC			8944

Anti-avoidance legislation –IR35
Special legislation to deter the payments of dividends applies to personal service companies, where work is done for an end client via the intermediary of a company but on terms which would have made the worker an employee if directly engaged by the end client. IR35 will apply to treat the receipts from the client as earnings on which PAYE should be operated. Similar rules apply to managed service companies which administer the finance of certain individuals providing services to clients.

Compliance requirements
There are also key filing dates. In addition to submission of company returns and accounts to Companies House, annual company returns need to be made to HM Revenue & Customs, although HMRC online filing provides a combined reporting system to Companies House. In addition, there are a number of key deadlines for submission of reports to HMRC with, as years go by, seemingly increasingly higher penalties. These include

Deadline	**Task**
19 April	PAYE tax and Class 1 NICs - postal payments must reach HMRC Accounts Office
22 April	PAYE tax and Class 1 NIC - cleared electronic payments to reach HMRC bank account
19 May	File Employer Annual Return (P35 and P14s)
31 May	Give each director/employee a form P60
6 July	File expenses and benefits annual return (forms P11D, P9D and P11D(b)) if applicable - give a copy to directors/employees
19 July	Class 1A NICs - postal payments to reach HMRC Accounts Office
22 July	Class 1A NICs - cleared electronic payments to reach HMRC bank account

Note: The above is intended as a general overview. Many of the points mentioned, such as losses, can be complex in themselves and specialist assistance may be recommended.

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