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Incorporation

The issue of whether to run your business as a company or a sole trader or partnership is an important one. In this factsheet, we summarise the potential tax savings available from operating as a company.

Is trading as a limited company the best option?

In our view it is generally beneficial, in tax terms, to trade as a limited company as there are annual tax savings.

Is it better to take a dividend rather than an increase in salary?

In our view there is generally a benefit for a director-shareholder to take a dividend rather than further salary.

Tax savings

The examples below give an indication of the 2021/22 tax savings that may be achievable for spouses or civil partners who are currently in partnership.

| Profits: | £50,000 | £100,000 |
|----------------------------|---------|----------|
| Tax and NI payable: | £ | £ |
| As partners | 8,067 | 22,567 |
| As company | 7,245 | 19,782 |
| Potential saving | 822 | 2,785 |

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 take a salary of £8,840 from the company with the balance (after corporation tax) paid out as a dividend.

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 tax and national insurance (NI) rates 2021/22

Rate of corporation tax

Profits are taxed at 19%.

Taxation of dividends

The cash dividend received is the gross amount potentially subject to tax. The rates of tax on dividend income are 7.5% for basic rate taxpayers, 32.5% for higher rate taxpayers and 38.1% for additional rate taxpayers.

A Dividend Tax Allowance taxes the first £2,000 of dividends received in a tax year at 0%.

National Insurance

The rate of employees' national insurance contributions (NICs) is 12%. In addition, a 2% charge applies to all earnings over the NIC upper earnings limit (£50,270 for 2021/22). The rate of NICs for the self-employed is 9%, and 2% on profits above £50,270 for 2021/22.

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.

Pension provision

As an employee/director of the company, it should be possible for the company to make pension contributions (subject to limits) to a registered fund irrespective of the salary level, provided it is justifiable under the 'wholly and exclusively' rule. Pension contributions are deemed to be a private expense for sole traders or partners.

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 may be 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.

Relief for goodwill

Generally where goodwill is sold to the company for cash or debt on or after 3 December 2014, individuals are prevented from claiming Business Asset Disposal Relief (BADR), and capital gains tax (CGT) arises on the gain. The exceptions to this rule are that a claim to BADR is allowed:

- for partners in a firm who do not hold or acquire any stake in the successor company
- where the individual claiming relief holds less than 5% of the shares and the voting power of the acquiring company
- where an individual holds 5% or more of the shares or voting power if the transfer of the business to the company is part of arrangements for the company to be sold to a new, independent owner.

Property taxes

Depending on where the property is situated there will be Stamp Duty Land Tax (SDLT), Land and Buildings Transaction Tax (LBTT) or Land Transaction Tax (LTT) 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 Pay As You Earn (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 (RTI). 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 e.g. for the 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 there are many factors to consider. We would welcome the opportunity to talk to you about your own specific circumstances. Please do not hesitate to contact us.