Incorporation: the advantages and disadvantages

Recent reductions to the rate of Corporation Tax have will result in a single rate of 20% by 2015, regardless of profit levels. When contrasted with the current 45% top rate of income tax for individuals and other recent increases to National Insurance rates, unincorporated businesses may wish to consider converting to limited company status.

Basic difference

A company is a separate legal entity from its owners. This means that profits arising from a business owned by a limited company are taxed differently from the profits of a sole trader or partnership business. This presents opportunities for tax planning.

Background

As a limited company is a legal entity in its own right, the income and gains it generates are subject to Corporation Tax payable by the company, and then the owners/managers are only taxed on the income they take from it, for example dividends and salaries.

Unincorporated businesses are deemed to be the possession of the proprietor and therefore the owner is taxed on the full profits earned by that business, irrespective of how much they draw from it for personal use.

Advantages of Incorporation:

- **Tax Rates:**
  Currently a stand-alone company with profits up to £300,000 is subject to corporation tax at 20%. An effective rate of 21.5% applies to the next £1.2m of profits, and a 21% rate applies to profits over £1.5m. Please note these profit bands are split between all of the “associated” companies.

  From April 2015, irrespective of profit levels or associated companies, there will be just one rate of corporation tax – 20%.

  If you consider that currently income tax rates on the profits of an unincorporated businesses are 20% (up to £31,865), 40% (on the next £118,135) and 45% (on all amounts in excess of £150,000), the corporation tax rates are favourable. If you consider the current rates of National Insurance (NI) on unincorporated business profits is charged at a rate of 9% on (profits up to £41,865) and 2% (thereafter), the corporation tax rates become even more desirable.

- **Remuneration Planning**
  The profits remaining in the limited company after the corporation tax has been paid can be extracted by the shareholders in a number of ways, which presents a greater opportunity for tax planning.

  For example, the company can declare dividends to be paid to the shareholders. Dividends are not subject to NI, and have an effective rate of income tax of 0% to the extent the individual shareholder has their basic rate tax band available.

  In addition to this, depending on the facts of the unincorporated business in question, it may be possible to incorporate the business and create a loan account due to the businesses previous owners at a very low tax cost. Amounts can then be withdrawn from this loan account at no further tax cost.

  Remuneration planning needs to be tailored carefully to meet the needs and circumstances of the individual business, but an incorporated business has significantly more scope for tax planning in this area than an unincorporated business. An incorporated business also has more options for employee incentives.

  In general, incorporation can result in significant tax savings for those businesses intending to re-invest profits back into the business in order to fund future growth.

- **Non Tax Advantages**
  Shareholders in a limited company enjoy limited liability status. This means that in theory their risk is limited to the amount of money that have invested into the limited company, and not unlimited as with unincorporated businesses. It should be noted that particularly for owner-managed businesses it may not always be this straightforward. Many finance providers will ask owner-manager shareholders to provide personal guarantees when helping to fund such limited companies.
Once formed, a company exists until it is wound up and can be passed between owners by the sale or transfer of shares.

Disadvantages of Incorporation

**Double Tax Charge**
As set out above, company profits are subject to corporation tax. The, depending on the method of extraction they can be subject to tax again in the hands of the recipients.

Dividends received by an individual with no basic rate tax band available will be subject to higher rate tax on those dividends at the rate of 25% and/or 30.6%. This effectively taxes the profits of the company twice.

Dividends that are declared by a company are payable to the shareholders in accordance with their shareholdings, they are not declared on an individual basis. This means that they can be inflexible and in some cases this can limit their usefulness. It can be quite costly if a salary or bonus has to be paid instead.

An effective double tax charge can also arise if the business assets have to be sold, or if the business has to be wound up, rather than the shareholders ending their association with the business via a share sale.

**Tax Losses**
Generally losses incurred by an unincorporated business are more favourable than losses in a limited company due to the rates of tax involved. Furthermore, subject to limits introduced in 2013, losses incurred by an unincorporated business can be set against the owner’s other income, whereas a company’s losses must remain within the company and are not available to the proprietors.

Incorporation for loss making businesses should be given serious consideration before being implemented.

**Company Cars**
The proprietors of unincorporated businesses are able to claim tax relief on the business use of the initial purchase (spread over a number of years) and the running costs. Other than that there are no further tax consequences.

A limited company can claim full tax relief on the purchase and running costs of the vehicle, however, the individual user would have a benefit in kind on the car and possibly on private fuel (if provided). Depending on the car, these costs can be quite significant. As a result of this the tax costs can be far more onerous in a company.

An employee may provide their own car, and claim a mileage allowance, which may be more tax-efficient than having the company provide the car.

Anti-avoidance measures

Some of the tax benefits of incorporation for some businesses can be eroded or removed entirely as a result of anti-avoidance legislation. The IR35 legislation was introduced for ‘Personal Service Companies’ to prevent them benefitting from the tax advantages of paying a nominal salary and substantial dividends. There is also legislation in place to limit the tax advantages that can be achieved by transfer of income between family members, for example by way of dividends.

Non-tax considerations

As a separate legal entity, a company is subject to significantly more legislation and regulation than an unincorporated business.

Typically on formation there are more legal and administrative costs than setting up an unincorporated business. Companies must prepare each year’s accounts in accordance with the requirements set out in the Companies Act and then file them at Companies House within a fixed time frame. Those accounts are then available for public inspection. There is a further deadline for the filing of the Company Annual Return, which incurs a small filing fee.

Companies are also required to keep statutory records and record events such as share transfers and the appointment of directors at Companies House.

Summary

Whether or not a business should incorporate depends very much on the facts in each particular case, and there is no shortcut to analysing the specifics and reaching a considered conclusion.

Once a decision to incorporate has been reached, there is again no shortcut to a considered and properly carried out implementation plan, featuring a post incorporation remuneration plan.

To discuss the advantages and disadvantages of incorporation, contact

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