SMALL BUSINESSES – TO INCORPORATE OR NOT TO INCORPORATE?

In recent years there have been a number of important changes affecting business and personal taxation, and now may be a good time to review the pros and cons of incorporating your business.

COMMERCIAL IMPLICATIONS

It is very important to bear in mind that the decision should be made primarily on commercial grounds. Although the tax implications may be very significant, they will not normally outweigh commercial considerations.

For some businesses, incorporation may not be possible as there are restrictions on the use of companies for carrying on certain types of professional work, such as barristers and the NHS practices of Doctors and Dentists.

One reason for favouring incorporation is that this enables you to operate with the benefit of limited liability. This can be especially important if the business is "high-risk" or particularly prone to litigation claims. Examples are to be found in the building trade and certain consultancy businesses. A major claim from a customer/client could potentially bankrupt your business and you as proprietor. Of course, if the business is carried on through the medium of a company, the company could be forced into liquidation. However, unless you have given personal guarantees, or security, your own liability would be limited to the amount you have invested in the company.

Another important benefit from operating through a company is that it enables a share incentive scheme to be set up. A properly structured share scheme offers a method of incentivising key staff in a way which simply would not be possible in an unincorporated business.

Confidentiality is another important matter. A sole trader or a partnership does not need to publish a profit and loss account or balance sheet. However, limited companies over a certain size must file detailed financial information each year with the Registrar of Companies, and this information is available to the public, including of course your competitors.

In addition, there are a number of other ways of carrying on a business, apart from as a sole trade, a partnership or a limited company. For instance, an "unlimited company" may be used. Although an unlimited company still has to be registered at Companies House, it is not necessary to file the same level of detailed financial information as applies with many limited companies.

A further option has recently become available with the introduction of the limited liability partnership. This is a "cross" between a partnership and a limited company, and offers the advantages of limited liability combined with a low level of public disclosure of financial information.

We shall be happy to steer you through the various structures and advise which is the best approach in your particular circumstances.

TAX IMPLICATIONS

Having considered the commercial background, it is also necessary to consider the tax implications of incorporation.

The top rate of personal Income Tax is currently 40%. In addition to this, a self-employed person (including a partner) must pay 7% National Insurance Contributions on profits between £4,615 and £29,900. From 6 April 2003, the 7% rate becomes 8%, and a 1% rate is payable on profits above £29,900.

As far as companies are concerned, the rates of Corporation Tax are:-

Taxable profits	Up to £10,000	Nil
Taxable profits	£10,001 - £50,000	23.75% marginal rate
Taxable profits	£50,001 - £300,000	19%
Taxable profits	£300,001 - £1,500,000	32.75% marginal rate
Taxable profits	Above £1,500,000	30%

However, it would be wrong to conclude from the above that it is always cheaper in tax terms to operate through the medium of a company. For example, further tax may have to be paid when funds are withdrawn from a company by the proprietor, e.g. by way of dividends, or if the company is eventually liquidated. Also, if salaries or wages are paid to directors or other employees, these will normally reduce the taxable profit, but they will also be taxed in the hands of the recipient. In addition, both the employer company and the employee will have a National Insurance liability depending on the level of earnings, although the employer's liability will again reduce the taxable profit for Corporation Tax purposes.

There is also a "double capital gains tax effect" which can impact a company owning a property or certain other assets. If the company sells the asset, it will have to pay Corporation Tax on the gain, subject to an indexation allowance deduction to allow for inflation. However, further tax will effectively be payable in respect of the same gain when the shareholder sells his (or her) shares in the company, or when he (or she) receives a lump sum in respect of the shareholding on the winding-up of the company. Although this liability may be alleviated by Taper Relief the "double capital gains tax effect" may be an unpleasant surprise for the unwary.

Unfortunately, it is not possible to take advantage of the nil rate of Corporation Tax on small profits by setting up a number of companies, each of whose profits would be below

£10,000. There are anti-avoidance rules which prevent any advantage being gained in these circumstances!

NO SIMPLE ANSWERS!

In very broad terms, the proprietor of an unincorporated business liable to tax at 40% needs to earn one-third more pre-tax profit to fund capital requirements (including loan repayments) out of income than a company liable at the 19% rate.

However, there are no "rule-of-thumb" solutions. Careful analysis will be needed in each case to arrive at the right decision. It is also necessary to look at the long-term tax position in connection with the ownership of assets such as freehold property, long leases and goodwill. As mentioned earlier, the total tax ultimately payable on disposal of assets of this kind can be considerably greater where a company is the owner. Problems can also arise if you are considering the transfer of a business property into a new company. There are some potential tax pitfalls here, and the transfer will need to be carefully structured in order to optimise the tax position.

If you do decide to incorporate and your new company is a "personal service company", it may be caught by the new legislation introduced in April 2000 which affects this kind of company. In some cases, incorporation could be a futile exercise, since you may subsequently be held by the Revenue to be "employed" by your clients!

We have discussed Income Tax, Capital Gains Tax and Corporation Tax, but it is also important to consider VAT, Stamp Duty and Inheritance Tax, which are outside the scope of this Memorandum.

OUR ROLE

It can be seen from the foregoing that incorporation is not a decision to be taken lightly without proper analysis of your individual circumstances.

We can assist you to:

- evaluate the impact of low Corporation Tax rates on your earnings profile when compared with the payment of Income Tax and National Insurance Contributions. A comparative cash flow summary will assist in illustrating the issues

- review your business plan for the next, say, three years and explore such issues as dividend payments, cessation of trade for Income Tax purposes, working capital generation, and the financing and ownership of assets

- achieve incorporation, if this is desirable
- consider post-incorporation pension planning
- consider whether the newly – available medium of a limited liability partnership may be more appropriate than incorporation.

We have considerable experience in assisting clients to restructure their businesses and will be delighted to discuss your particular circumstances with you, if you so wish.

FOR GENERAL INFORMATION ONLY

Please note that this Memorandum is not intended to give specific technical advice and it should not be construed as doing so. It is designed merely to alert clients to some of the relevant issues and is not intended to give exhaustive coverage of the topic.

Professional advice should always be sought before action is either taken or refrained from as a result of information contained herein.