Is incorporation still an option?

PRIYA KOTECHA busts the myths and clarifies the facts relating to changes in legislations relating to limited companies

FACTFILE

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Everyone's best pal, George, seems to have had too much time on his hands lately what with the ridiculous number of changes he has made to our tax system.

As it is, one of the big four firms of accountancy practices in the UK already investigated and found that the British tax system has become the most complex in the world. And it looks like we are becoming more complex all the time. Our tax code is a whopping 17,000 pages long compared to Hong Kong's 276 pages!

One area which has seen a huge number of changes lately is legislation relating to limited companies as well as to income derived from them. It is important to note that incorporations (when a sole trader or partnership changes structure to a limited company) are still possible however in many cases, potential benefits of doing this may have disappeared. It is also still possible to buy a new practice into your own limited company or indeed to buy a new practice as a limited company. Again the tax merits of each have to be considered very carefully. Generally speaking, where you have the choice of buying either assets or shares, you will normally prefer to buy assets (unless there is an NHS contract in the new practice and this is already in the name of the limited company, in which case you may have little choice but to buy the shares). You should always take advice before doing anything though!

'INCORPORATIONS ARE STILL POSSIBLE, HOWEVER, IN MANY CASES, POTENTIAL BENEFITS OF DOING THIS MAY HAVE DISAPPEARED'

JARGON BUSTER

As always, here is a quick jargon buster before we get started:

Incorporation – converting a sole trader or partnership (unincorporated) into a limited company by transferring or selling the assets of the business to a new limited company.

Limited Company – a legal entity owned by its shareholders who appoint directors to look after it. The shareholder and the director may be the same person, but even in that case, the limited company is legally separate and distinct from that individual.

Share purchase – when you are buying a business which already trades as a limited company and you buy the shares of the business. This means you buy the whole business which contains within it the goodwill, equipment etc.

Asset purchase – when you when you are buying a business which already trades as a limited company and you buy the assets of the business (i.e. goodwill, equipment etc.). The actual limited company (the outer shell) stays with the vendor and you can either trade as a sole trader or partnership or buy the assets into your own (or a new) limited company).

So now let's move on to the exciting part – the changes!

1. Change 1 – No more directors loan accounts

This change has been in place for a while now, but is one of the main reason why there has been a drop in the number of people incorporating. Previously, if incorporating, it was possible for you to sell your goodwill to your new limited company. The gain that you made (market value of goodwill less the cost of goodwill) qualified for entrepreneur's relief, so you were able to pay a flat 10% rate of capital gains tax (CGT) on the gain. Your company then owed you the market value of the goodwill which was basically the sale price of your goodwill (a sum which you had effectively loaned to the company so it could buy your goodwill from you) so you were allowed to take up to this amount out of the company's taxed profits, without suffering additional tax yourself on these withdrawals. In December 2014, this was changed so you would have to pay the full rate of CGT (28% at that time, but 20% now) to take advantage of this "directors loan" account. There are other ways (and reliefs available) so you can still incorporate, but the directors loan account is generally not available for drawdown unless you are happy to pay the higher rate of CGT.

2. Change 2 – Reducing corporation tax

This is currently set at 20% but will drop to 19% from 2017 and 17% in 2020. This is obviously some good news amidst all the gloom!

3. Change 3 – overhaul of dividend tax

We had always feared that one day, the chancellor would start charging national insurance on dividends, making them more expensive. Instead of doing this, the Chancellor completely overhauled the tax system in relation to dividends, broadly speaking resulting in an increase of 7.5% tax across the board (though those with dividends under £5,000 will now pay no tax on these at all)

The first £5,000 of dividend income in each tax year is now tax-free. Sums above that are taxed at 7.5% for basic-rate taxpayers, 32.5% for higher-rate taxpayers and 38.1% for additional-rate taxpayers.

Under the old system, basic-rate taxpayers paid NO tax on their dividend income, while higher-rate taxpayers paid an effective rate of 25% and additional-rate taxpayers paid 30.56%. This is expected to raise £6.8m for George.

MAIN TAX CHANGES

CHANGE 1
No more directors loan accounts

CHANGE 2
Reducing corporation tax

CHANGE 3
Overhaul of dividend tax

DO YOU HAVE INCOME PROTECTION? IF SO, YOU NEED TO CHECK YOU WILL STILL BE ADEQUATELY COVERED

SO IS IT STILL WORTH INCORPORATING?

It may be but you need to be sure it will work for you. Some of the things you should consider are:

1. If there is an NHS contract involved, is this a PDS or a GDS contract, and if a PDS, is it possible to convert to a GDS? Also, how does the LAT feel about incorporation? Remember that to also incorporate the NHS part, the NHS contract must be in the name of the limited company.
2. If you have both NHS and private income, look at the possibility of incorporating just the private part if not possible/feasible/worthwhile to incorporate the whole practice.
3. How long do you envisage owning the practice for (i.e. by when do you think you will get so fed up of it, you want to sell it!)
4. How much do you need to live on and do you have any other sources of income (with a limited company, you only pay personal income tax on the money you extract from the company so if you don't need all of it, you can leave some of it in the company for later when you may even be able to extract it more tax efficiently!)
5. What happens to your pension contributions? Again, it is usually a choice between getting the company to pay or you paying personally.
6. Do you have income protection? If so, you need to check you will still be adequately covered.
7. Coupled with points 1, 2 and 3 – you also need to have a better idea of your exit strategy and how a sale will be structured (the tax treatment is different depending on whether it will be a share or asset sale and as we have already discovered, if the NHS contract is already in the name of the limited company, your only option will probably be to sell the shares).
8. A new lease may need to be created for the property.

These are just a few pointers to get you started but as you can see there are a number of variables to consider.

Once you decide it is going to be right for you, you just need to go through the process and make sure you go through all the correct steps (your accountant will help you). Most of these are not too onerous and cover things like speaking to your bank regarding any existing loans you have, starting a new payroll scheme, new contracts for staff and associates etc., new bank account and credit card terminal, new literature and stationery etc. You will also need a solicitor who will deal with the incorporation by preparing a sale and purchase agreement etc. I couldn't end without a jibe at my solicitor friends: 'What is the difference between an accountant and a solicitor? The accountant knows she is boring.' We love you really! OP