CHAPTER 24

INCORPORATION

24.1 Introduction

Where a sole trader transfers his business to a limited company and thereafter trades via the medium of a company, he is said to have "incorporated" his business.

In this chapter, we shall concentrate on the tax implications of a sole trader transferring his business to a company, looking at:

- Income tax;
- Capital gains tax;
- National Insurance;
- VAT;
- Corporation Tax;
- Inheritance Tax; and
- Stamp Duty Land Tax.

We will also take a brief look at legal and compliance issues of incorporation and at the methods available for extracting funds from the new company.

Although we will look specifically at a sole trader transferring his business to a limited company, the rules we will cover apply equally for partnerships which incorporate their businesses.

24.2 Income tax

Cessation of trade

The incorporation of a business by a sole trader brings about a cessation of trade for income tax purposes. The closing year rules will therefore need to be considered, including relief for overlap profits.

Capital allowances

On the cessation of trade, plant and machinery is deemed to be sold to the new company for consideration equal to the lower of actual consideration and original cost resulting in **balancing adjustments**.

The disposal of the plant and machinery to the company will give rise to balancing allowances (if the disposal value of the plant is less than the tax written down value) or balancing charges (if the disposal value of the plant is more than the tax written down value).

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If any plant and machinery is purchased **in the final accounting period, no annual investment allowance, first year allowances or writing down allowances** are available.

Illustration 1

Jason Lee runs a haulage business in the north-east. On 31 December 2010 he incorporated his business by transferring the trade and assets to Lee Light Haulage Ltd. Jason is managing director and 100% shareholder of the company. Overlap profits being carried forward are £18,000.

Recent profits were as follows:

	Adjusted profit before CAs	Capital allowances	Trading profit
	£	£	£
6 m/e 31.12.10	48,000	Note	?
Year ended 30.6.10	75,000	(15,000)	60,000
Year ended 30.6.09	64,000	(12,000)	52,000

The tax written down values of Jason's plant and machinery at 1 July 2010 were as follows:

	General pool	Expensive car (100% business use)
	£	£
TWDV at 1.7.10	30,000	12,500

On 15 July 2010, Jason purchased a new trailer for £7,000. On incorporation at 31 December 2010, the consideration paid to Jason was £36,000 for the plant and £16,000 for the car (original cost £21,500).

We shall calculate his taxable profits for 2010/11.

We first calculate capital allowances for the final 6-month accounting period up to the date of cessation:

	General Pool	*Expensive Car*
	£	£
TWDV b/f	30,000	12,500
Additions:		
Trailer	7,000	_____
	37,000	12,500
Disposals:	(36,000)	(16,000)
Balancing allowance /(charge)	1,000	(3,500)
Net balancing charge	£(2,500)	

The balancing charge increases the trading profits of the final 6 months:

	Adjusted profit	Capital allowances	Trading profit
	£	£	£
6 m/e 31.12.10	48,000	2,500	50,500

The trading profits for the final 2 tax years of trade are:

	£
2009/10	
Year ended 30.6.09	52,000
2010/11	£
6 m/e 31.12.10	50,500
Year ended 30.6.10	60,000
	110,500
Less: Overlap relief (given)	(18,000)
Taxable 2010/11	£92,500

The new company will have the following capital allowance pools at 1 January 2011:

Lee Light Haulage Ltd:

	General Pool	*Car*
	£	£
TWDV b/f	36,000	16,000

No annual investment allowance or first year allowances are available as the assets are acquired from a connected person.

Planning point

If the assets are transferred for consideration of just £1, this is likely to create a significant balancing allowance, potentially relievable at a rate of 40% or even 50% which could be good news for the sole trader.

However, do remember that the company will only include £1 as the cost of its plant and machinery additions for the purpose of calculating future capital allowances!

S.266 / S.267 CAA 2001

CAA 2001, s.266

Where plant and machinery is transferred between connected persons, **a joint election** can be made (in writing to HMRC within 2 years of the transfer date) for the assets to be **transferred at tax written down value**.

The election can have the effect of cancelling a balancing charge on cessation.

If Jason and the new company jointly elect under s.266, the capital allowance position will instead be as follows:

	General Pool	*Car*
	£	£
TWDV b/f	30,000	12,500
Additions:		
Trailer	7,000	
	37,000	12,500
Transfer @ TWDV	(37,000)	(12,500)
Balancing allowance /(charge)	Nil	Nil

As the balancing charge has been cancelled, this will decrease the trading profits in the final tax year as follows:

2010/11	£
6 m/e 31.12.10	48,000
Year ended 30.6.10	60,000
	108,000
Less: Overlap relief	(18,000)
Taxable 2010/11	£90,000

The new company will acquire Jason's capital assets at their TWDV at 1 January 2011:

Lee Light Haulage Ltd

	General Pool	*Car*
	£	£
TWDV b/f	37,000	12,500

Again no annual investment allowance or first year allowances are available.
Stock

On incorporation, the sole trader will transfer his stock to the company. As this will be a transfer of stock between connected persons, the stock is deemed to have been **sold** to the company for an amount equal to its **market value**.

ITTOIA 2005, s. 177

The market value of the stock will therefore form part of sales in the final accounting period. If the market value of the stock exceeds its acquisition cost, a trading profit will arise on the transfer. That profit will be charged to income tax.

The recipient of the stock (in this case the new company) is deemed to have bought the stock for its market value.

Where stock is **transferred between connected persons**, the two parties may make an **election** under s.178 ITTOIA 2005 for the stock to be treated as transferred for the **higher of**:

ITTOIA 2005, s. 178

a) its acquisition value (ie, the cost to the sole trader); or
b) the amount the stock was actually sold for (ie, the cash paid by the company to the trader).

The election is joint and must be made by the anniversary of the filing date of the relevant self-assessment return (i.e. for cessations in 2010/11, the stock election should be made by 31 January 2013).

Illustration 2

Penny is a newsagent. On 1 April 2011 she transferred her business to a limited company, Pen's Papers Ltd. Details of her stock in hand on the cessation of her sole trade on 31 March 2011 is as follows:

	£
Cost of stock	5,000
Value of stock at 1.4.11	8,000
Amount paid by Pen's Papers Ltd	NIL

1. No election under S.178 ITTOIA 2005:

	£
Deemed selling price = Value of stock at 1.4.11	8,000
Less: Cost of stock	(5,000)
Taxable profit in p/e 31 March 2011	£3,000

Pen's Papers Ltd is deemed to have bought the stock for £8,000.

2. Election under S.178 ITTOIA 2005:

	£	£
Deemed selling price:		
Higher of:		
a) acquisition cost	5,000	
b) actually selling price	NIL	
		5,000
Less: Cost of stock		(5,000)
Taxable profit in p/e 31 March 2011		NIL

Pen's Papers Ltd is deemed to have bought the stock for £5,000.

The election has the effect of reducing the sole trader's profit to zero (and thereby reducing profits in the final year) and also reducing the acquisition cost of the stock for the company. In effect, the company will pay more tax when it sells the stock.

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Losses

If the sole trader has losses in the final year of trade (prior to incorporation), there are 4 options for utilising the loss:

1) **S.64 ITA 2007** - the loss can be relieved against net income of either the year of the loss and/or the preceding year.

2) **S.71 ITA 2007 (s.261B TCGA 1992)** - after a s.64 claim has been made in a tax year, some of the loss can be converted into a capital loss and set against capital gains in that same tax year.

3) **S.89/90 ITA 2007 (terminal loss relief)** - the loss can be relieved against trading profits of the year of cessation and the previous 3 years. Losses are relieved against later years before earlier years (LIFO basis).

4) **S.86 ITA 2007** - the loss can be carried forward and relieved against any income taken by the former sole trader from the new company. Losses are relieved against employment income before dividends.

   To qualify for this loss relief there is a requirement that 80% of the consideration on incorporation is in shares and that these shares are still retained in the year that the relief is to be taken.

   Note that the losses CANNOT be carried forward and relieved against the future profits generated by the new company.

You should note that in practice it is much more likely that a sole trader will incorporate a profit making business, as the loss rules for income tax are more flexible than they are for corporation tax.

24.3 Capital Gains Tax

The transfer of business assets by an individual to a company is a disposal for capital gains tax. The disposal takes place with **proceeds deemed** to be market **value** because the sole trader and the company are **"connected persons"**.

TCGA 1992, s.18
TCGA 1992, s.286

The sole trader will therefore have a capital gain on the chargeable assets at the point of incorporation. The chargeable assets will usually be land and buildings and goodwill. It is unlikely that gains will arise on other assets such as plant and machinery as these will either be standing at a loss (for which relief is given via the capital allowances computation) or any gains will be exempt under the chattels rules.

Gains on chargeable assets can be wholly or partly deferred by **"incorporation relief"** under s.162 TCGA 1992.

TCGA 1992, s.162

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Incorporation relief

Incorporation relief is calculated by taking the capital gain and multiplying it by a fraction as follows:

Gain on transfer of land and buildings	X
Gain on transfer of goodwill	X
Total gains	X
Less: incorporation relief	
Gains x $\dfrac{\textbf{Value of shares received}}{\textbf{Total consideration}}$	(X)
Gain after incorporation relief	X

TCGA 1992, s. 162(4)

Incorporation relief is a deferral relief. The deferred gain is rolled over and set against the base cost of the individual's shares in the company. Therefore this gain will effectively be charged when the individual eventually sells the shares.

Base cost of shares in new company:

	£
MV of shares at incorporation	X
Less: incorporation relief	(X)
Base cost of shares	X

If the value of shares received is the same as the total consideration received by the individual from the new company, the incorporation relief fraction will be one. In this instance the whole of the gain will be deferred and no gain will remain chargeable.

Therefore, a chargeable gain will only arise if the company pays for the business assets with something other than shares (for example, loan stock).

It is common in practice for a company to offer loan stock to the sole trader in consideration for a transfer of the assets. This is usually done by the company opening a "director's loan account" - this is effectively a loan made by the sole trader to the company for the acquisition of his assets.

The sole trader will become a director of the company and will "cash-in" the loan (i.e. draw money out of the loan account) as and when the company can afford it.

There are **3 conditions to be satisfied before incorporation relief is given**:

TCGA 1992, s.162(1)

1) The business transferred must be a **"going concern";**

2) **All assets** of the sole trader **(except cash)** must be transferred to the company to obtain the relief. This means that if the sole trader wishes to retain any assets – such as land or buildings – outside the company, he will not be given incorporation relief; and

3) The **consideration** paid to the individual by the company, must be **wholly or partly in shares**.

Incorporation relief is automatic and no formal claim is necessary. It is not possible for the taxpayer to restrict his incorporation relief "claim" so as to make sure he uses his annual exemption.

However it is possible for the taxpayer to take a specific amount of loan stock / directors' loan account, so as to generate a gain equal to his annual CGT exemption.

Illustration 3

Jason Lee incorporates his sole trader business on 31 December 2010 by transferring assets to a new company, Lee Light Haulage Ltd.

The assets transferred are his business premises and vehicle depot, goodwill, machinery and current assets, which are valued as follows:

	MV	Cost
	£	£
Business premises	175,000	60,000
Vehicle depot	100,000	40,000
Goodwill	150,000	NIL
Plant and machinery	52,000	
Current assets (cash and debtors)	23,000	
MV of business at 31 December 2010	500,000	

He acquired the premises and the depot in September 1988 when he started trading.

Lee Light Haulage Ltd offers Jason £400,000 in ordinary shares and £100,000 left outstanding on director's loan account.

In the absence of any further information we assume that the plant and machinery is exempt under the chattels rules.

Jason's capital gains position is as follows:

	Premises	Vehicle Depot	Goodwill
	£	£	£
Proceeds (MV)	175,000	100,000	150,000
Less: cost	(60,000)	(40,000)	NIL
Gains	115,000	60,000	150,000
Total gains		325,000	
Less: incorporation relief			

$$\text{Gains} \times \frac{\text{Shares received}}{\text{Total consideration}}$$

$£325{,}000 \times \frac{400000}{500000}$	(260,000)
Chargeable gain	£65,000

The base cost of Jason's shares in Lee Light Haulage Ltd is:

	£
MV of shares	400,000
Less: incorporation relief	(260,000)
Base cost of Jason's shares	£140,000

The new company is deemed to have acquired Jason's assets on 31 December 2010 with the following base costs (equal to market value at transfer):

	Premises	Depot	Goodwill
	£	£	£
Base cost at 31.12.10 (MV)	175,000	100,000	150,000

As well as owning shares, Jason also has £100,000 of "loan stock" in Lee Light Haulage Ltd. This is simply an "IOU" between the company and Jason. As Jason has paid CGT on the loan stock, he can draw this cash out of the company at any time in the future without any further liability to CGT.

During the time that the company owes Jason £100,000, Jason could charge interest on the loan. The interest is taxable on Jason. The company must withhold tax at 20% on any interest payments, but can deduct the interest payments when calculating its corporation tax liability. Many director / shareholders charge interest on loan accounts as this is a way of extracting money from the company free of PAYE and NIC.

Optimum share consideration to utilise annual exemption

It is possible to calculate the amount of loan stock/ director's loan account required to generate a chargeable gain (after incorporation relief) equal to the CGT annual exemption. For example, in the case of Jason from illustration 3, the position would be as follows:

	£
Total gains	325,000
Less: incorporation relief	
Gains x $\frac{\text{Shares received}}{\text{Total consideration}}$	
£325,000 x $\frac{\text{Shares received}}{500,000}$	(314,900)
Chargeable gain	10,100
Less: annual exemption	(10,100)
Taxable gain	NIL

We know that Jason's total gains before incorporation relief are £325,000 from which we will deduct incorporation relief to arrive at his chargeable gain. We want his chargeable gain to be exactly £10,100 because this will be covered by his annual exemption, leaving him with taxable gains of nil. Therefore we want his incorporation relief to be £314,900 (£325,000 - £10,100).

We now have an equation to solve in order to calculate the optimum amount of share consideration:

$$£325,000 \times \frac{\text{Shares received}}{500,000} = 314,900$$

$$\text{Shares received} = 484,462$$

The optimum share consideration is therefore £484,462 which means that the rest of the total consideration must be received in the form of loan stock or director's loan account.

Consideration to be received as:	£
Shares	484,462
Loan stock	15,538
Total consideration	£500,000

Entrepreneurs' relief

TCGA 1992, s. 169H

Entrepreneurs' relief can be claimed by sole traders and partners disposing of their businesses. Therefore, where a sole trader transfers his business to a limited company, any gains arising on the incorporation can be reduced by entrepreneurs' relief.

The way the relief works was changed in F(No.2)A 2010 with effect from 23 June 2010.

Disposals prior to 23 June 2010

For disposals prior to 23 June 2010, entrepreneurs' relief worked by reducing qualifying gains by 4/9ths. The remaining 5/9ths of the gain was then charged at 18%, giving an **effective tax rate of 10%.**

The relief was only available on the first £2 million of lifetime capital gains (this lifetime limit was £1m for disposals pre 6 April 2010). Individuals could claim relief for gains on multiple occasions up to a cumulative total of £2 million. Gains in excess of the £2 million threshold were then charged at 18%.

Entrepreneurs' relief was given AFTER incorporation relief. Therefore if full incorporation relief was given, there was no chargeable gain to be reduced by entrepreneurs' relief.

Disposals from 23 June 2010 onwards

For disposals from 23 June 2010 onwards, the lifetime limit has been increased to £5 million. Individuals can now claim relief for gains on multiple occasions up to a cumulative total of £5 million.

The way in which entrepreneurs' relief is applied has also changed. From 23 June 2010 onwards the rate of capital gains tax payable by an individual depends on their taxable income for the year. If an individual has taxable income below the basic rate limit, gains that fall in the basic rate band are taxed at 18% and any gains above the basic rate limit are taxed at 28%.

To maintain the "effective rate" of tax at 10% for all individuals who dispose of assets qualifying for entrepreneurs' relief, the relief is now given by **taxing the qualifying gains at 10%.** There is no 4/9ths reduction. Therefore the relief now applies when calculating the capital gains tax liability rather than reducing the chargeable gain.

This change in method was made to ensure that an individual will always be taxed at an effective rate of 10% on gains qualifying for entrepreneurs' relief, regardless of when during 2010/11 the disposal was made.

Illustration 4

Returning to illustration 3, Jason Lee incorporates his sole trader business on 31 December 2010 in return for shares and loan stock. His capital gains position is as below:

	£
Total gains	325,000
Less: incorporation relief	
Gains x $\frac{\text{Shares received}}{\text{Total consideration}}$	
£325,000 x $\frac{400000}{500000}$	(260,000)
Chargeable gain – qualifying for ER	£65,000

Assuming that Jason has made other disposals during 2010/11 which use up his annual exemption, entrepreneurs' relief will be applied as follows:

	£
Chargeable gain – qualifying for ER	65,000
CGT @ 10%	£6,500

Remember, entrepreneurs' relief may also be available on a subsequent disposal of the shares provided the individual has both owned at least 5% of the shares and worked for the company for at least one year prior to the sale of the shares.

Disapplying incorporation relief

Even though incorporation relief is automatic (assuming the conditions have been satisfied) the taxpayer can elect under s.162A TCGA 1992 to disapply incorporation relief if he doesn't want to have it.

TCGA 1992, s. 162A

This will be a consideration for individuals who have not utilised full entrepreneurs' relief and who may not be eligible for entrepreneurs' relief on a future sale of their shares in the company (for example, if they no longer work for the company at the date of sale).

Illustration 5

Jason Lee incorporates his sole trader business on 31 December 2010 by transferring assets to a new company, Lee Light Haulage Ltd. His chargeable gains on incorporation are £325,000.

Lee Light Haulage Ltd offers Jason £400,000 in ordinary shares and £100,000 left outstanding on director's loan account.

Jason elects under S.162A TCGA 1992 to disapply incorporation relief. Again he has made other disposals during 2010/11 which use up his annual exemption.

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His CGT position is now as follows:

	£
Chargeable gain – qualifying for ER	325,000
CGT @ 10%	£32,500

The base cost of Jason's shares in Lee Light Haulage Ltd is:

	£
MV of shares	400,000
Less: incorporation relief	(NIL)
Base cost of Jason's shares	£400,000

The election has increased Jason's CGT by £26,000 (£32,500 - £6,500). However the CGT base cost of his new shares has been uplifted by £260,000 (£400,000 - £140,000) which will save CGT as and when his shares are sold.

An election to disapply incorporation relief will therefore be a good idea when entrepreneurs' relief will not be available on a future disposal of the shares.

Gift relief alternative

TCGA 1992, s. 165

If an individual gives away a business asset, the donor and the donee can make a joint election to defer the gain under the gift relief provisions in s.165 TCGA 1992. This applies in the same way if the donee is a company. Therefore gift relief can be used as an alternative to incorporation relief where a sole trader transfers his business to a company.

A sole trader may consider making gift relief claims if he does not wish to transfer all of his business assets to the company. One of the conditions for incorporation relief is that all of the individual's assets must be transferred to the company.

Therefore, if the sole trader wishes to retain an asset – for example, a building – outside the company, the only way to obtain capital gains tax deferral relief would be to claim gift relief instead. One reason why a taxpayer may not wish to transfer the building to a company is in order to save stamp duty land tax on the transfer.

Following a gift relief claim, the deferred gain is rolled over and reduces the base cost of the asset in the hands of the company. It does NOT reduce the base cost of the taxpayer's shares.

If full gift relief is given, there is no chargeable gain left to benefit from entrepreneurs' relief 10% rate of tax.

Illustration 6

Jason Lee incorporates his sole trader business on 31 December 2010 by transferring assets to a new company, Lee Light Haulage Ltd. His Balance Sheet at 31 December 2010 is as follows:

	MV	Cost
	£	£
Business premises	175,000	60,000
Vehicle depot	100,000	40,000
Goodwill	150,000	NIL
Plant and machinery	52,000	
Current assets (cash and debtors)	23,000	
MV of business at 31 December 2010	500,000	

Jason decides to retain ownership of the vehicle depot as it stands on potentially valuable development land near the local Tesco supermarket. There are rumours that Tesco want to expand its store and may wish to make Jason an offer for the land in a few years time.

He therefore transfers the remaining assets to the company and retains the vehicle depot. He will rent the depot out to Lee Light Haulage Ltd at a commercial rent. This is another method of extracting cash from the company without paying NIC.

The retention of the depot also reduces the Stamp Duty Land Tax liability.

Jason's capital gains position is as follows:

	Premises	Goodwill
	£	£
Proceeds (MV)	175,000	150,000
Less: cost	(60,000)	NIL
Gains	115,000	150,000
Total gains	265,000	

Jason is not entitled to incorporation relief as he has not transferred all of his business assets. However, the gains on the premises and the goodwill can be deferred using gift relief as follows:

	Premises	Goodwill
	£	£
Gains	115,000	150,000
Less: s.165 gift relief	(115,000)	(150,000)
	NIL	NIL

The deferred gain is rolled over and reduces the base cost of the assets in the hands of the company:

Company	Premises	Goodwill
	£	£
MV at 31.12.10	175,000	150,000
Less: deferred gains	(115,000)	(150,000)
Base cost for company	60,000	NIL

The effect of a gift relief claim is to reduce the base cost of the assets in the hands of the new company. This means that Lee Light Haulage Ltd will have a higher corporation tax liability as and when it sells its assets.

The base cost of Jason's new shares in Lee Light Haulage Ltd will simply be the amount he actually paid for them when he set up the company. This could be as little as £1! Jason will therefore have a higher CGT liability when he comes to sell his shares.

One of the key **downsides of the gift relief route is the potential "double charge" to tax** when the individual decides to make an exit from the business by winding-up the company. The double charge will arise because:

1. The company will sell its assets (e.g. goodwill, buildings etc). As the assets have a low base cost, a potentially large capital gain will arise in the hands of the company which will be charged to corporation tax in the final accounting period; then

2. The shareholder will wind-up the company and extract the cash. The cash extracted will be sales proceeds for CGT. As the shares have a low base cost, there will also be a potentially high chargeable gain on the disposal of the shares. The same "value" has therefore been charged to both corporation tax and CGT. The individual's gain may be eligible for entrepreneurs' relief.

In the majority of instances, where a sole trader is transferring all of his assets to the company, it is beneficial for the sole trader to take incorporation relief as opposed to gift relief.

24.4 National Insurance (NIC)

When a sole trader transfers his business to a company, he will be changing his status for national insurance purposes.

Sole traders pay NIC under Class 2 and Class 4. Class 2 contributions are fixed (£2.40 per week for 2010/11) and are paid either monthly or quarterly.

Class 4 contributions are based on the taxable trading profits and are charged at 8% between the upper and lower profit limits and at 1% on profits in excess of the upper limit. Class 4 NICs are collected with income tax under the self-assessment system.

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Note that Class 4 NICs (like income tax) are charged on the taxable profits of the business for the tax year, irrespective of whether the trader draws the profits out of the business. The trader's actual drawings are irrelevant for tax and NIC purposes.

This regime will no longer apply once the sole tradership has ceased.

Once the business is transferred to a limited company, the individual will be a director / shareholder of the company. If the director / shareholder wishes to extract funds from the business (for his own personal expenditure), he can essentially do so in one of two ways:

1. by payment of a salary (or employment related bonus); or
2. by the company declaring dividends to its shareholders out of its profits.

If a salary or bonus is taken by the director, the payment must by made under deduction of tax and NIC under the PAYE system. NIC is payable by the employee under Class 1 primary at 11% between the earnings threshold (£5,715 p.a.) and the upper earnings limit (£43,875 p.a.), and at 1% thereafter. In addition, employer's secondary Class 1 NIC at 12.8% must also be paid to HMRC whenever a salary / bonus payment is made.

For this reason, **it is often more expensive from an NIC perspective for an individual to receive salary from a company than to earn profits as a sole trader.**

Illustration 7

In 2010/11, Jason (a sole trader) has taxable trading profits of £90,000. His NIC liability for the year will be as follows:

		£
Class 2:	52 x £2.40	124.80
Class 4:	£(43,875 – 5,715) x 8%	3,052.80
	£(90,000 - 43,875) x 1%	461.25
Total NIC due		£3,638.85

Assume instead that Jason is a director of Lee Light Haulage Ltd and in 2010/11 he was paid a salary of £90,000. The NIC liability would be as follows:

	£
Class 1 primary NICs payable by Jason:	
£(43,875 – 5,715) x 11%	4,197.60
£(90,000 - 43,875) x 1%	461.25
	£4,658.85
Class 1 secondary NICs payable by Lee Light Haulage Ltd:	
£(90,000 - 5,715) x 12.8%	£10,788.48

As you can see, the NIC burden is significantly higher for a salary paid by a company, mainly because of the requirement for the company to pay Class 1 secondary NICs.

Note also that as Jason is a director, we calculate his NICs on an annual basis, regardless of his actual payment periods.

Liability to NICs can be avoided by Lee Light Haulage Ltd paying Jason dividends out of the company profits as opposed to paying a salary. The **advantages of a dividend** as opposed to a salary are:

- No NIC on dividends;
- No PAYE withholding on dividends;
- No tax liability on dividend income until income exceeds the higher rate threshold;
- Higher rate and additional rate tax on dividend income lower than that for non-savings income.

There are however **some disadvantages of a company paying dividends** as opposed to a salary:

- Dividends are not deductible for corporation tax purposes;
- Dividends do not count as "earnings" for pension purposes;
- Not paying NICs will reduce entitlement to state retirement benefits. The taxpayer could consider paying voluntary Class 3 contributions to maintain this entitlement;

- If the director has a contract of employment with the new company, HMRC could invoke the National Minimum Wage legislation if he fails to pay sufficient salary. This can be avoided by not having a formal employment contract.

- Dividends can only be paid if the company has "distributable reserves" (i.e. profits);

Also note that where dividends are declared, all shareholders will be entitled to the dividend. This will be an issue where there is more than one shareholder.

These problems can be avoided either by:

- Having different classes of shares; or
- One shareholder waiving his/her right to the dividend.

Often a sensible way of remunerating a director / shareholder is to pay a salary up to the level of the personal allowance (no PAYE, no NIC, a corporation tax deduction) and distribute the balance by way of dividends.

NIC Annual Maxima rules

SI 2001/1004 Reg 21

SI 2001/1004 Reg 100

If a sole trader incorporates his business part way through a tax year, he may pay Class 2 and Class 4 on sole trader profits for the first part of the tax year, then Class 1 primary NIC on salary taken from the company in the second part of the tax year.

Where a taxpayer has paid Class 1, Class 2 and Class 4 NICs in the same tax year, the annual maxima rules need to be considered.

Two tests are applied and if NICs paid exceed the maximum ceiling, some NICs will be refunded. Test 1 may lead to a repayment of Class 2 contributions. Test 2 may lead to a repayment of Class 4 NICs.

Alternatively the taxpayer can apply to NICO in advance and request a "deferment" of contributions. If deferment is granted, some NICs are postponed thereby preventing the need for an NIC overpayment to arise in the first place.

24.5 Value Added Tax (VAT)

If the sole trader is VAT registered, VAT will normally have to be charged where assets (land, plant, stock etc) are transferred in the course or furtherance of business.

However, **no VAT needs to be charged on the transfer of a business as a going concern** (a TOGC). A **TOGC** is not a supply of goods or services and is **outside the scope of VAT**. There is no output tax for the vendor and no input tax for the purchaser

SI 1995/1268 Reg 5

The conditions for there to be a TOGC are:

- the business transferred is a going concern;
- the purchaser (i.e. the new company) is or will immediately become VAT registered;
- there is no significant break in trading;
- the business carried on by the company is the same.

An incorporation will satisfy the above conditions in the majority of cases, so the sole trader will not have to charge VAT to the company.
The TOGC rules do not apply where:

- the sole trader owns land or buildings which are transferred to the company; and
- an "option to tax" has been made in respect of the land or buildings or the building being transferred meets the criteria 'new, freehold, commercial' (in other words, the building would be a standard rated supply if sold in isolation).

In this case, VAT must be charged to the company at the standard rate and paid by the sole trader to Customs. The new company can then reclaim the VAT if it uses the land / buildings to make taxable supplies.

While the VAT will usually be repayable to the company, it does create a cash-flow problem, as there could be a delay of several months between the company paying the VAT then reclaiming it via its VAT returns.

However, no VAT needs to be charged on such land / buildings if the company makes an option to tax in respect of the said land / building. The land / building will then pass to the company without VAT being charged as part of the TOGC transfer. However the company will charge VAT on any future supplies it goes on to make with the said land / building (e.g. on its eventual sale).

The **sole trader must deregister** his sole trade business for VAT purposes within 30 days by sending form VAT 2 to Customs. The **new company should then register for VAT**.

The new company can elect to use the sole trader's old VAT registration number. However, this has the effect of transferring the past VAT history of the old business to the new company. Therefore, if the sole trader had committed any VAT misdemeanours, the liability for those would transfer to the new company.

If the VAT registration number is not transferred, the new company does not have any responsibility for the VAT affairs of the previous sole trader business.

24.6 Corporation Tax

The new company must notify HMRC of its chargeability to corporation tax within 3 months of starting to trade. Thereafter the company must file an annual return under corporation tax self-assessment.

In addition, accounts and annual returns must be submitted to Companies House in accordance with requirements under the Companies Act and such accounts (unlike those of the sole trader business) are open for public scrutiny. In general, the level of administrative responsibility is greater with a company than for a sole trader.

The company will pay corporation tax on its profits at a flat rate of 21% until profits in the accounting period exceed £300,000. For most sole traders there will therefore be a significant reduction in the tax charged on the business profits compared to the rate of income tax which is 40% and the additional rate 50%.

There is no tax on "undrawn" profits. Sole traders pay income tax on the profits of the business, irrespective of the level of their personal drawings. In a company situation, tax is only charged on amounts actually drawn from the company (for example in the form of salary or dividends).

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The new company is likely to be a close company as it will be controlled by 5 or fewer shareholders. The director / shareholder should be aware of the rules in s.455 CTA 2010 if he borrows money from the company (e.g. via an overdrawn current account). A 25% "penalty tax" charge is levied on loans to shareholders.

CTA 2010, s455

Note also that if goodwill is transferred to the company by the sole trader on incorporation, the goodwill will NOT be treated as an intangible fixed asset (IFA) for the company unless the sole trader started in business after April 2002.

CTA 2009, s 884

CTA 2009, s 835

The IFA rules do not apply if the company acquires pre-2002 goodwill from a connected person. The company will not therefore be able to receive tax relief for the amortisation of the goodwill in its accounts. The goodwill will be treated as a capital asset and any profit on a future sale will give rise to a capital gain.

CTA 2009, s 843

24.7. Inheritance Tax

IHT is charged on transfers of value i.e. where there is a reduction in the estate of the person making a transfer. In the case of a sole trader transferring assets to the company, there is no loss to his estate as a result of the transfer so there are no IHT issues. The sole trader is simply swapping one set of assets (land, plant, stock etc) for shares or loan stock in a new company.

The new shares / loan stock will have the same value as the assets given to the company, so there is no "loss to donor".

Business Property Relief will continue to be available at 100%. Both a sole trader business and shares in an unlisted trading company are eligible for 100% BPR.

However, having a company can make it easier for the owner of the business to pass down part of the business to his family. For example, it is far easier to give away shares in the business to one's children than giving them a fractional share of a building or goodwill.

A gift of shares will be a PET for IHT, qualifying for 100% BPR in the event that the donor dies within 7 years (assuming that the donee still owns the shares).

If a sole trader incorporates his business but retains ownership of a building (for example to avoid Stamp Duty Land Tax or to enable him to charge rent to the company), the building will also qualify for BPR. However the rate of BPR on a building owned by an individual and used by a company he controls is only 50%. Therefore if the taxpayer dies, 50% of the value of the building will be charged to IHT on his death.

IHTA 1984, s. 105

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24.8 Stamp Duty Land Tax (SDLT) on incorporation

There is no Stamp Duty on a new issue of shares by a company. Therefore where an individual incorporates a business by transferring business assets to the company in return for newly issued shares, there are no Stamp Duty implications and the ½% ad valorem rate of Stamp Duty will not apply.

There is also no Stamp Duty charged on the transfer of assets such as goodwill, plant, stock and debtors to the new company.

There is however a liability to Stamp Duty Land Tax (SDLT) where land and buildings are transferred to the company. The SDLT is payable by the company and is a percentage of the value of the land and buildings transferred.

The percentages are in your Tax Tables and are as follows:

Rate (%)	
Zero	Up to £150,000
1	£150,001 - £250,000
3	£250,001 - £500,000
4	Over £500,000

The relevant percentage is typically charged on the consideration passing. When the purchaser and vendor are connected persons (as will be the case for an incorporation), the consideration is deemed to be the market value of the land and buildings transferred.

FA 2003, s. 53

The allocation of total consideration between the various assets transferred must be specified to the Stamp Taxes Office and any apportionment must be on a "just and reasonable" basis. SDLT liabilities cannot be avoided by making separate transfers of land so as to utilise the zero or 1% bands.

FA 2003, s. 55(4)

Where transactions are "linked" (i.e. made as part of a single scheme or arrangement between the same purchaser and vendor), SDLT is charged as a percentage of the total market value.

The SDLT charge is triggered when the purchaser (in this case the company) substantially takes possession of the property. This will usually be on the completion of the contract. Note that the SDLT liability for the company could be significant and the tax is due and payable within 30 days of the completion. It is therefore important for the new directors of the company to arrange to have the necessary funds within the company to meet the SDLT liability.

The company will also need to submit a land transaction return within 30 days of the completion.

SDLT can be avoided by keeping any land and buildings outside the new company. If there is no transfer of land, there is no SDLT liability. The former sole trader / new director can instead retain ownership of the land and lease it to the company at a commercial rent. The rents will be taxable income for the new director, but there is no NIC liability. The rental payments are tax deductible for the company.

Assuming the director has control of the company (by owning more than 50% of the shares), BPR will be available at 50% in the event of a gift / death.

The major disadvantage of retaining the buildings outside the company is that incorporation relief under S.162 TCGA 1992 will be denied. Therefore an SDLT charge is often seen as the price the business has to pay for the advantages of securing S.162 relief.

It is of course possible to keep the land and make a S.165 claim in relation to the other chargeable assets transferred to the company (e.g. the goodwill), but this has certain downsides as previously discussed above.

24.9 Legal and compliance issues

Many sole traders incorporate their business to take advantage of "limited liability". Limited liability usually means that the members of a company (directors, shareholders etc) cannot be held liable for the actions or debts of a company. This is sometimes eroded by third parties such as banks etc, who often require personal guarantees from the directors / shareholders in respect of the company's overdraft or other borrowings. However the protection of limited liability nonetheless remains extremely valuable.

It is often easier for a company to raise additional finance from banks etc, than it is for a sole trader. Companies can also raise equity from outside investors via the EIS or VCT schemes (opportunities which are not available for sole traders).

Companies can also introduce share option/share incentive schemes to incentivise and retain key employees. Such schemes are not available to sole traders.

On the compliance side, considerable burdens are imposed on companies, which do not apply for sole traders. The sole trader who becomes a director must therefore learn to have more financial discipline when running a company.

Companies must maintain minutes of directors meetings and accounts must be filed annually with Companies House and be open for public inspection.

A sole trader will therefore lose a degree of flexibility in his business arrangements when he incorporates his business.

24.10 Extraction of funds

Finally in this chapter let's just summarise some of the different methods of extracting funds from the newly formed company. Some of these methods have already been mentioned earlier on in this chapter, but some methods are new.

Salary

Salaries can be paid to the directors, either as regular sums or as more infrequent bonuses and are tax deductible for the company.

A salary / bonus is subject to income tax in the hands of the directors.

In addition to the class 1 NIC payable by the directors / employees, the company will have to pay class 1 secondary NIC at a rate of 12.8% on the gross salary / bonus.

Dividends

Dividends are paid out of the company's post tax profits; i.e. there is no corporation tax relief for dividends paid.

Net dividends are effectively only liable to income tax in the hands of the shareholder if they are a higher rate or additional rate tax payer. The "effective" rate of income tax paid is 25% in the higher rate band and 36.1% in the additional rate band.

Dividends, however, are not subject to NIC.

There is a legal requirement that dividends can only be paid out of accumulated distributable reserves. This means that if the company makes a loss in a particular year then dividends can still be paid provided that the sum of all the previous years retained profits is positive.

Rent

If on incorporation the sole trader or partners retain ownership of a business property which is occupied by the company, the individual can charge the company rent for its use.

They sole trader/ partners will be subject to income tax on the rental profits but no NIC will be due.

The company will obtain a corporation tax deduction for the rent paid.

However, there may be Entrepreneur's Relief restrictions when the individual eventually disposes of the building in the future.

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Interest

If on incorporation the sole trader or partners receive some of the consideration in the form of loan stock or as a directors' loan account, they can charge interest on the loan until it is repaid by the company.

The sole trader/ partners will be subject to income tax on the grossed up interest received but no NIC will be due.

The company will obtain a corporation tax deduction for the gross interest paid on an accruals basis (unless the interest is paid more than 12 months after the end of the accounting period to which it relates, in which case corporation tax relief is given in the accounting period in which the interest is paid).

The company must withhold 20% income tax on any interest payments made. These are paid over to HMRC via the CT61 return.

There are no tax consequences for the sole trader/ partners when the loan is repaid.

Pension Contributions

The company can pay pension contributions for its directors / employees.

It will obtain a corporation tax deduction for pension contributions if the payments satisfy the 'wholly and exclusively' rule and have been paid in the accounting period.

HMRC have gone on record saying that they will not deny relief where the director shareholder receives a small salary and the remainder of their remuneration is a mixture of dividends and pension contributions, and the pension contributions exceed the level of earnings (i.e. exceed the salary).

Corporation tax relief will typically be given for contributions up to the level of the company's profits in the year.

There is no taxable benefit for the directors for the contributions made by the company into their personal pensions.

There are no NIC implications of pension contributions for either the company or the directors.

However, remember that the amount by which total pension savings are allowed to increase each year cannot exceed the Annual Allowance (£255,000 in 2010/11). If this amount is exceeded, the individual will be subject to a tax charge of 40% on the excess.

There will be a special annual allowance charge if total pension savings exceed the special annual allowance (normally £20,000) where a higher earner (income of £130,000 or higher) changes their regular pension savings.

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Additionally, if the Lifetime Allowance (£1.8m in 2010/11) is exceeded, there is a charge of either 25% of the excess if taken as a pension or 55% if taken as a lump sum.

Childcare Vouchers

Partnerships cannot obtain a taxable deduction for paying childcare vouchers to the partners. However, directors of a limited company are employees of that company and can benefit from the provision of childcare vouchers.

Where vouchers are provided up to £55 per week, this is not a taxable benefit for the director and no NIC is payable.

The company may claim a corporation tax deduction for the cost of the vouchers.

Other Benefits

Finally, there are a range of other benefits that the company could provide to the directors.

The most common type of benefit is the provision of a company car.

In nearly all cases an income tax liability will arise and Class 1A NIC will be payable by the company but it will often end up being more cost effective for the company to pay for the provision of the benefit rather than the individual paying for it personally out of post tax income.

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