

## Should you form a limited company?

**Tax changes have made it even more important to consider carefully, when running a business, whether it is best to trade as:**

- Sole trader - an individual
- Partnership - two or more individuals or companies
- Limited liability partnership
- Limited company

We are often asked, 'Should I form a limited company?' The reality is that there is no easy answer. Each situation has to be judged individually. As well as the obvious issues of tax and national insurance contributions (NICs), there are many other potentially relevant factors, such as:

- The business
- Its expected rate of growth
- The degree of commercial risk
- Administrative obligations
- Personal preferences
- Pensions and retirement

In the early years of a business, the privacy of operating as a sole trader or partnership may be attractive. Business funds can be used with fewer restrictions than in an incorporated environment.

However, we are considering here the features of a limited company. A company is a completely separate legal entity subject to two main areas of regulation - tax and company law. This planning guide looks at some of the advantages and disadvantages of trading as a limited company. Please do contact us if you want more specific help or advice.

### Possible advantages of incorporation

- Incorporation normally provides limited liability. If a shareholder has paid fully for his or her shares, he or she cannot normally be required to invest any more in the company. Although companies with bank borrowings often have to provide directors' personal guarantees, the protection of limited liability will generally apply in respect of liabilities to other creditors.
- A company enjoys legal continuity - it can own property, sue and be sued.
- Effective ownership or part ownership of the business may be readily transferred, subject to the provisions of the Articles of Association. Whilst such transfers may well be covered by inheritance tax business property relief, the capital gains tax position needs careful review.
- Normally a bank can take extra security by means of a 'floating charge' over the assets of the company, and this will increase the amount that can be borrowed compared with a sole trader or partnership.
- Shareholders can be paid in dividends (currently free of NICs) but strict company law formalities must be observed.
- The National Minimum Wage does not apply to directors (as they are office holders) unless they have a Contract of Employment.
- Growing businesses can re-invest profits after a corporation tax charge of 21% (if profits are below £300,000), compared with 40% income tax for higher-rate tax paying sole traders and partners together with a 1% class 4 National Insurance charge on profits over £43,875.
- Accumulated funds could be withdrawn on a sale of shares with the benefit of capital gains tax (CGT) entrepreneur's relief which reduces the capital gains tax to an effective rate of 10% on the first £1,000,000 of capital gain. Thereafter any gain is chargeable at a flat rate of 18%.
- Corporate status is sometimes thought to add to the credibility or commercial respectability of the business.
- A company can establish a registered pension scheme, which may provide greater benefits than self-employed schemes.

- Employees may, with adequate safeguards, be offered an opportunity to buy their own stake in the business, reflecting their commitment and importance to the company.
- The liability of executors acting for deceased shareholders, or of trustees, is clearly defined.

### Potential disadvantages of incorporation

- Formation of a company incurs legal and administrative costs, which may include new accounting records and possibly systems, new PAYE system, new business tax reference, new VAT registration, new stationery etc.
- Customers, suppliers and service providers must be informed of a change to limited company status.
- The tax position arising on the incorporation of an existing business needs careful analysis. It may be possible to defer capitals gains tax on the transfer of goodwill etc, but the timing and effect of cessation on income tax must be closely planned.
- Annual accounts must comply with the requirements of the 2006 Companies Act. In most cases, a statutory audit is not required for companies with an annual turnover of £5.6 million or less. The statutory audit involves work over and above that which is normally carried out for a sole trader or partnership.
- A company's accounts must be filed on public view with the Registrar of Companies. An Annual Return must also be submitted to the Registrar of Companies together with a filing fee of £30 (£15 if filed online).
- The company will be taxed on its profits of each accounting period, as opposed to the income tax 'current year' basis for sole traders and partnerships. A company must file a corporation tax return.
- Funds withdrawn from a company normally give rise to tax liabilities, whereas owners of unincorporated businesses can generally introduce and withdraw cash without tax implications.
- Remuneration for directors is subject to both employee's and employer's National Insurance liabilities - currently up to 23.8%. For example on a remuneration of £30,000 there is a NI liability of £5,779. Both the company and its directors are liable to NIC on many benefits in kind, and a form P11D must be prepared for each director, whatever the level of earnings. This can lead to extra work in filing a tax claim for reimbursed expenses etc for which individual tax relief is available.
- Tax on directors' remuneration paid monthly is payable on the 19th of the following month (22nd for electronic payment) through the PAYE system, and corporation tax is payable nine months after the end of a company's accounting period. For a sole trader or partnership, tax is generally paid by instalments on 31 January and 31 July on the current year basis. The 'credit period' depends upon the choice of accounting date, and you should contact us for further advice on this.
- The IR35 Legislation relating to personal service companies could be relevant, especially for IT contractors and other service providers who work for only one customer.
- Companies pay tax on capital gains at their corporation tax rate (21% for profits up to £300,000). In a company, a capital gain is reflected in the value of its shares and if these are sold a "double charge" to capital gains tax can arise. This may be avoided if assets that are likely to increase in value are owned either outside the company or within a self-administered pension scheme, or if a company is sold complete with its assets
- An individual has greater flexibility in dealing with trading losses.
- A company director is more at risk of criminal or civil penalty proceedings, e.g. for late filing of accounts or for breaching the insolvency rules.

There can be no substitute for a detailed analysis, and we are happy to help you in any way we can.

**Please contact us if you would like further help or advice on this subject.**