Tax Options

INCORPORATION

A technical outline of the tax planning opportunities
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INTRODUCTION

This report will consider the benefits of incorporating a business, whether currently operating as a sole trader or partnership, and the various issues to consider when choosing the best method to adopt.

This is not intended to be an exhaustive treatment of the subject but to highlight a number of issues that crop up in practice with suggested solutions where appropriate.

It is assumed that the basic rules are understood by practitioners but for completeness we have included extracts from HMRC manuals and legislation which practitioners may find useful.

The principles discussed generally apply equally to sole traders and partnerships. In these situations, a sole trader will be used as an example. There are some issues specific to partnerships that will be considered separately.

TAX BENEFITS OF INCORPORATION

1. Introduction

The tax benefits of incorporation come in two parts. The main benefit derives from how much income is required and the method of drawing that income. The secondary benefit derives from the manner in which the business is incorporated. This secondary benefit is explored further under the Methods of Incorporation section.

2. Remuneration - summary

As a sole trader, profits are liable to income tax and class 4 national insurance regardless of whether profits are reinvested into the business (as fixed assets, working capital or simply surplus cash) or withdrawn.

A major benefit of a company is that profits are subject to corporation tax but any profits retained within the company, whether to finance the business or simply because the shareholder has no need for more personal cash, are not subject to income tax.

However, in some cases, particularly companies that are primarily the vehicle for providing the services of a single individual (often termed one man companies), there is no great need for much working capital and the individual may wish to withdraw all the profits for personal use. Even here the company can produce significant tax savings. This comes because the individual can usually take a small salary and the balance by dividend. This avoids the national insurance costs – both employer’s and employee’s – associated with higher salaries. Where a company is used and all profit is withdrawn as salary, the company is more expensive than a sole trader as class 1 national insurance associated with salary is much higher than class 4 national insurance for the self-employed.

An example based on 2011/12 tax rates in included in **APPENDIX 1**
which illustrates the comparison of a sole trader, a company with profit withdrawn as salary and a company with profit withdrawn as a small salary and the balance as dividend. In each case all the profit is withdrawn and so the comparison is between the post-tax returns to the individual. Based on a profit of £40,000, the example shows a post-tax benefit of £2,999 using a company with a low salary high dividend policy compared with a sole trader.

3. Level of low salary

When adopting a low salary high dividend strategy, the optimum salary depends on the circumstances.

A salary between the lower earnings limit (£5,304 in 2011/12) and the secondary threshold (£7,072 in 2011/12) will not attract any national insurance cost but will mean that the individual has a qualifying year for basic state pension purposes and is also deemed to have been paid £14,400 (in 2011/12) for additional state pension purposes.

It should be noted that 2011/12 is the first year when the primary threshold (the point at which an employee starts to pay national insurance) has been decoupled from the secondary threshold (the point at which the employer starts to pay national insurance). As the secondary threshold at £7,072 is slightly lower than the primary threshold at £7,225, the salary should be capped at the secondary threshold to avoid any national insurance contributions.

Setting the salary equal to the personal allowance (£7,475 in 2011/12) ensures that none of the personal allowance is wasted (remember that dividend tax credits cannot be reclaimed) but creates some national insurance cost.

However, the national insurance cost is greater than the income tax saving and so setting the salary at the secondary threshold is preferred. In any case, the individual may have other income that can utilise the balance of his personal allowance.

4. National minimum wage

A salary of £7,072 is below the national minimum wage ("NMW") for a full-time worker. The current NMW for someone 21 or over is £5.93 (£6.08 from 1 Oct 2011) an hour which represents an annual salary of some £12,350 (£12,650 from 1 Oct 2011) for a 40 hour week.

Can an individual be paid less than the NMW?

The NMW rules only apply to a person with a contract of employment. H M Revenue & Customs accepts that a person who is an officer of a company (director or company secretary) can work for his company without a contract and so is not bound by the NMW rules.

However, if a person wishes to claim working tax credits, a change in the regulations with effect from 6 April 2003 [para 3(3) of Working Tax Credit (Entitlement and Maximum Rate) (Amendment) Regulations 2003] means that technically a person without a contract of employment is not eligible to make a claim. Thus, to make a claim a contract is required and hence a minimum salary equal to the NMW is also required.

5. Pension contributions

As a sole trader, pension contributions can be made up to 100% of profits, subject to the annual cap reduced to £50,000 with effect from 6 April 2011. Such contributions do not reduce profits for class 4 national insurance purposes.

Operating via a company, the individual has two choices. He can make contributions up to 100% of salary (what is termed "relevant income" for pension contribution purposes) or the company can make contributions on his behalf (again both subject to the annual cap). Personal contributions are generally not recommended as they do not save national insurance (however, see comments below).

It is quite acceptable for a person to receive a small salary combined with dividends and for the company to make a substantial pension contribution on his behalf. In order for the company to claim corporation tax on the contribution, it is necessary for the overall remuneration package (salary, pension contribution and benefits, if any) to be reasonable. The fact that the pension element may represent, say, 90% of the package is irrelevant. In 2005, when issuing draft guidance in relation to the pension changes starting on “A day” (6 April 2006), H M Revenue & Customs suggested that the pension element had to be reasonable in relation to the size of the salary. However, this view was subsequently retracted.

The comment about personal contributions being less tax efficient than company contributions is not always true. In some cases the individual may not be able to reduce his salary in favour of dividends. This might be because he has a salary from a separate employment or outside shareholders in a family company make it less desirable to pay large dividends. In these sorts of circumstances he has sufficient “relevant income” to allow payment of personal contributions but he may also be receiving some dividends.

A personal contribution is made net of basic rate tax at 20%. Higher rate tax relief is then claimed separately. If a higher rate tax payer receives dividends, the higher rate tax (based on a 40% rate) net of the 10% tax credit is 22.5% of the gross dividend (i.e. the dividend inclusive of the tax credit). Thus £1 of gross pension contribution reduces the higher rate tax on the dividends by 22.5p. Overall the tax relief on the pension contribution is therefore 42.5% - 20% plus 22.5%.

6. Cars

One possible disadvantage of incorporation is the tax treatment of cars. Detailed consideration of the taxation of company cars is considered in a separate report [Company cars] but some general comments follow.

As a sole trader, an individual can claim for the costs of running a car based on a percentage of actual costs calculated according to the number of business miles compared with total mileage in any year.

Operating as a company, an individual can either run the car through the company or continue to run it in his own name.

As a company car, the company can claim corporation tax for all costs but the individual will suffer a benefit-in-kind charge calculated according to its list price and CO_2 emissions. He will also suffer a car fuel benefit charge if the company pays for his private fuel consumption.

As a private car, the individual can charge the company 45p per mile for business mileage up to 10,000 miles a year and 25p per mile thereafter. Such receipts are tax-free.

As a general rule, it is not economic to suffer a car fuel benefit charge unless private mileage is of the order of 20,000 miles a year.

Equally, as a general rule, it is more economical to run a car in an individual’s name if the car is expensive and/or has high CO_2 emissions.

Clearly it is necessary to perform a calculation based on detailed circumstances.

Again, for a more expensive car, it is unlikely that the tax-free charges that an individual can make to the company will not cover a reasonable share of his actual costs.

In conclusion, there is likely to be some disadvantage in relation to motor expenses where a business is incorporated and the car concerned is expensive and/or has high CO_2 emissions. For a cheaper and/or low CO_2 emissions car, it may be beneficial.

A possible way to avoid this problem is to continue to run the car through a sole trader business that supplies the individual's services to the company. There are a number of practical problems associated with such a solution not least the administration cost. Accordingly it is unlikely to be cost effective unless there are a number of directors who could operate this way in partnership.

7. Income shifting

If an individual's spouse pays tax at a lower rate than the individual, it is beneficial to shift some income from the individual to the spouse.

If the individual is a sole trader, this is possible in one of two ways.

The first is to employ the spouse in the business and pay a salary. The difficulty with this depends on how much work the spouse does for the business. In most small businesses, the spouse will assist to some degree but the level of involvement will vary from very little to full-time. To be deductible for income tax purposes in the sole trader's business (and if it isn't then it will cost extra tax – not save it), the level of salary must be appropriate for the duties performed by the spouse.

A way of avoiding this problem is for the spouse to become a partner in the business. Profits may then be allocated, perhaps 50:50, without regard to the respective level of duties. A drawback with this solution is the commercial risk of exposing the spouse to unlimited liability. This could be overcome by using a limited liability partnership – either the old style (under the Limited Partnerships Act 1907 – not commonly used) or the new style LLP.

With a company, the process of shifting income to a spouse is generally much easier.

Again the spouse can receive a salary. As for the main individual, this is likely to be capped at the national insurance secondary threshold (£7,072 in 2010/11) regardless of the level of involvement of the spouse. If the spouse is appointed as an officer of the company (director and/or company secretary) justifying the level of salary is less difficult as it would be reasonable to pay a small salary to a non-executive officer even if they do very little.

If the spouse is given shares in the company, dividends can be paid even if the spouse does absolutely nothing in the business.

It is worth making some brief comments about income shifting legislation. This subject is covered in more detail in the report [Tax Planning for Married Couples].

If income is shifted from one spouse to another then it can be taxed on the transferor spouse if the gift is not outright or it is "wholly or substantially a right to income" [ITTOIA 2005 s626]. In the case of Jones v Garnett [2007] STC 1536, also known as the Arctic Systems case, it was held that a gift of ordinary shares, even in a company such as Arctic Systems Ltd, which was effectively a one man company to supply the services of Mr Jones, was not caught by the exclusions in s626. The corollary is that if the shares given to the spouse are restricted in some way, e.g. non-voting, there is a risk that the exclusions will apply.

In 2007 the Government announced its intention to reverse this decision and introduce income shifting legislation. Thankfully this was dropped in 2008 as the proposals would have been a nightmare to implement. So this issue is on the back burner for the time being.

8. Partnerships

Typically a partnership will be incorporated into a single company. However, it can be advantageous to incorporate each partner separately, i.e. create a partnership of companies.

In these circumstances, each company is liable to corporation tax on its own share of the partnership profits. The benefits of this compared with a single company are:

a. Each company can deal with its profit share as it pleases independently of actions by other companies. Thus one company might pay all its profits as dividends to shareholders, another might make large pension contributions and a third retain profit for investment.
b. By splitting profits between different companies, the rate of corporation tax payable is likely to be lower. For example a single company with £600k profit will pay corporation tax at 20% (2011/12 rates) on the first £300k and 27.5% on the next £300k making an average rate of 23.75%. If the business was operated by two or more companies in partnership sharing profits equally, all profits would be liable to 20% - an annual saving of £22.5k.

The second benefit is most likely to be relevant to professional partnerships, such as accountants and solicitors, who historically have operated as unincorporated businesses but have been steadily converting to companies over the last few years.

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METHODS OF INCORPORATION

1. Introduction

When a business is incorporated there are three basic ways of doing it. Each one has its advantages and disadvantages.

The three routes are

a. A simple sale or gift of assets
b. A transfer of assets in exchange for an issue of shares
c. A cash subscription for shares followed by a sale of assets at full value

Each of these routes will be considered in turn. It cannot be overemphasised that it is important to decide which route to adopt and then to ensure that it is implemented correctly.

The first of these routes is the one most commonly adopted but the other two have certain advantages in the right circumstances.

2. Summary

The following is a summary of the relative advantages and disadvantages of each method:

a. A simple sale or gift of assets
   - Flexible – property can be retained
   - Simple
   - Loan account can be created at a nil or modest tax cost (depending on the size of the loan account)

b. A transfer of assets in exchange for an issue of shares
   - Base cost of chargeable assets increased to market value without tax cost
   - Can be used for property letting businesses
   - All assets (other than cash) including property must be transferred
   - Loan account can be created but at a generally much higher tax cost than in the other two routes

c. A cash subscription for shares followed by a sale of assets at full value
   - Flexible – property can be retained
   - Base cost of chargeable assets transferred increased to market value without immediate tax cost
   - Loan account can be created at a nil or modest tax cost (depending on the size of the loan account)
   - Need to comply with Enterprise Investment Scheme rules

3. Goodwill

Whichever route is adopted (although the second two routes allow goodwill to be transferred at full market value without immediate tax cost), goodwill is transferred to the company.

The market value of goodwill will depend on the type of business. In some businesses largely dependent on the skills of one or two individuals, it may be that most or all of the goodwill is personal to those individuals and therefore the market value of goodwill that can be transferred (often termed “free goodwill”) is nil or very small. In other cases, where buildings are specifically designed for a particular trade (hotels, restaurants and nursing homes are common examples), it may be argued that most of the goodwill is inherent in the property (often termed “inherent goodwill”) and so that part can only be transferred if the property is transferred. In these circumstances the split between inherent goodwill and free goodwill will depend on the facts in each case.

Assuming there is at least some free goodwill to transfer then, if the business was first established on or after 1 April 2002, the company will be able to claim tax relief for the amortisation of the goodwill under the intangible fixed asset rules found in CTA 2009 Part 8. Tax relief cannot be claimed for amortisation of inherent goodwill.

4. A simple sale or gift of assets

The steps to implement this route are

a. A company is set up with the desired issued share capital held by the desired shareholders. This may be as low as a single £1 share, a modest 100 £1 shares or higher.
b. The business assets are transferred to the company at prices ranging from a nominal £1 to full market value. The considerations when choosing the amount are dealt with in section 4.1 below. Note that no shares are issued as consideration for the transfer of assets.
c. Any consideration for assets transferred is left outstanding as a loan to the company.

4.1 Consideration for assets

The appropriate consideration for each type of asset is considered below.

i. Debtors

Assets such as debtors are normally transferred at book value on the assumption that book value equals market value.

ii. Stock

Depending on the nature of the business, the market value of stock may exceed cost. If stock is transferred at a price in excess of cost then there will be an income tax charge on the sole trader. Assuming that this will be charged at 40% it will generally be sensible to avoid this by transferring stock at cost. In such circumstances, it is necessary to make an election under ITTOIA 2005 s178, to transfer the stock at the greater of cost or the price paid. In the absence of such an election, the stock will be deemed to be transferred at market value regardless of actual consideration.

iii. Plant and machinery

The consideration for plant and machinery will be sale proceeds for the sole trader. Because the company will be eligible to claim capital allowances on any expenditure itself, the actual price stands and market value is not substituted. Thus, for example, the sole trader could transfer the plant at £1 and obtain a balancing allowance. This is particularly useful where the sole trader's profits in the final period before incorporation will take him well into higher rates. The drawback of a sale at a low price is that the loan account created by the sale will be reduced.

iv. Goodwill

As a general rule goodwill should be transferred at a price approaching to or equalling market value. There may be a reason to set a lower price and this issue is considered further in section 4.2 on page 12.

The principle here is that, by incurring a 10% capital gains tax cost upfront, the person will be able to withdraw cash instead of dividends that would be subject to higher rate tax. The effective rate of higher rate tax on a dividend is 25% (for a 40% taxpayer) or 36.1% (for a 50% taxpayer).

To the extent that the price is set below market value, part of the gain can be held over under TCGA 1992 s165. Thus, in most cases, the net gain will be based on actual proceeds rather than market value.

The profit on the disposal of goodwill should be eligible for entrepreneur's relief and thus only be subject to 10% capital gains tax.

v. Property

Whether property is transferred is a more difficult decision.

The benefit of retaining it is to protect it against a failure of the company.

The benefit of transferring it is to enhance the value of the loan account in a similar manner to goodwill.

One downside of retaining it is that it will cease to be eligible for 100% business property relief for inheritance tax purposes. Provided that the company is controlled by the individual and his spouse, the rate of relief drops to 50%. If he does not control the company then relief is lost completely. Thus, for example, if the original business is a partnership of two individuals who are not spouses and the property is retained, all relief is lost. This problem can be overcome, whilst preserving protection, by using two companies. The property is put into a holding company and the trade into a wholly owned subsidiary of the holding company.

Another downside of retention is if there is a mortgage outstanding against the property. In order to obtain tax relief for the mortgage interest, it will be necessary to charge the company a rent at least equal to the interest. It does not have to be a full market rent. If rent is charged then, if the property is sold at a later date, part or all of the capital gain will not be eligible for entrepreneur's relief.

If the property is transferred, there will be a stamp duty land tax cost based on the full market value of the property regardless of actual consideration.

If the decision is made to transfer the property the price should be set between its base cost for capital gains tax purposes and full market value. The issue of the appropriate price level is considered further in section 4.2 below.

As with goodwill, to the extent that the price is set below market value, part of the gain can be held over under TCGA 1992 s165. Thus, in most cases, the net gain will be based on actual proceeds rather than market value.

4.2 Size of the loan account

The value of the net assets sold, including the chosen price for goodwill and any property, will create a loan account within the company.

The benefit of the loan account is to allow cash to be withdrawn from the company at a later date without tax cost.

As dividends are tax free within the basic rate band, the strategy will be to take a salary up to the national insurance secondary threshold (£7,072 in 2011/12), a dividend up to the basic rate band limit (£31,500 in 2011/12 being 90% of £35,000) and anything further as a loan withdrawal. With a spouse, this could mean receiving nearly £80,000 a year tax-free (the company paying corporation tax of course) without touching the loan account.

Thus the person's circumstances, his requirements for cash and the profitability of the company will determine how quickly the loan account is likely to be used.

If the rate of use is likely to be low, there seems little point in setting the price for goodwill and, if applicable, property as high as possible as this will generate immediate capital gains tax costs.

Another issue to consider, particularly if the potential loan account is large, is inheritance tax. The original unincorporated business is likely to qualify for 100% business property relief. The shares in the new company should also qualify for 100% relief but the loan account is a separate asset and will not qualify for any relief.

It may well be that the perceived short term benefits of the loan account outweigh this potential inheritance tax issue but it is important to ensure that anyone incorporating his business is aware of this issue.

A possible solution to the problem is to issue redeemable preference shares in place of part of the loan. The idea is that enough loan would be left to cover likely withdrawals over, say, a two year period, with redemptions of preference shares taking place to top up the loan as required.

Redeemable preference shares can qualify for 100% business property relief.

If there is a simple conversion of loan account into shares, business property relief may only available after the shares have been held for two years. However, it is likely to be possible to claim immediate relief by reason of the replacement property rule in IHTA 1984 s107.

5. A transfer of assets in exchange for an issue of shares

The steps to implement this route are

a. A company is set up with only a single subscriber share that is not paid up.
b. The business assets excluding cash but including any property are transferred to the company in exchange for an issue of new shares (including paying up the subscriber share). Optionally the consideration can be part cash part shares – see 5.2 below.
c. Cash can be lent to the company or retained for personal use as required.

Relief is claimed under TCGA 1992 s162 to roll over gains on goodwill and property into the base cost of the shares acquired.

S162 requires that all business assets other than cash be transferred. This means that any property must be transferred incurring a stamp duty land tax charge based on its full market value. Cash can be transferred for shares as well but the only benefit of doing this is to retain business property relief for inheritance tax purposes. Apart from inheritance tax it will be better to retain the cash or lend the company as much as it might require.

The disadvantage of s162 is the inability to create much of a loan account without tax cost.

The advantage of s162 is that the company acquires chargeable assets at full market value. This is particularly useful where there is an expectation of selling some or all of the assets in the near future.

For example, a farmer operating as a sole trader becomes aware of the possibility of selling some of his land for development. He faces a substantial capital gain and the land sale will not be eligible for entrepreneur's relief assuming he is not selling a business. He incorporates his business using s162. The company can then sell the land generating little or no capital gain. The drawback is that the cash is locked up in the company but the farmer might be happy with this.

It should be noted that, if it is intended to use a partnership of companies (see section 8 above under Tax Benefits of Incorporation), this method of incorporation is not available as a requirement is that the whole business is transferred to a single company.

5.1 Incorporation of a property business

One particular advantage of s162 is that it only requires that a business be transferred – not a trade. Many tax reliefs, e.g. TCGA 1992 s165 (relief for gifts of business assets) may refer to business in their titles but the detailed rules state that they only apply to trading activities.

What is the difference between a trade and a business? It can be quite difficult to decide in some cases. A detailed discussion is beyond the scope of this report. Suffice it to say that trades are businesses but the term business can embrace a wider range of activities. The most obvious and common example is a property letting business.

Generally any activity, including letting a single property, is regarded as a business when undertaken by a company. However, for individuals, it is considered that there needs to be more substance to the activity. Thus letting a single property is unlikely to qualify. However, the more work that is involved in running the activity, the more likely it is to be accepted as a business. A portfolio of five or more let properties is likely to qualify (although this might be borderline) or a smaller number where more work is required, e.g. student lets.

As in the farmer example above, s162 allows a portfolio of properties to be transferred to a company rolling over the capital gains. The company may then sell one or more properties with little or no capital gain.

Again the cash is locked inside the company but it might be used, for example, to start a trading activity or a furnished holiday letting business. After a minimum of one year, the company can be wound up and entrepreneur's relief claimed. The gain eligible for entrepreneur's relief would include (perhaps nearly 100%) of the gain originally rolled over under s162.

The drawback of this is that there is a stamp duty land tax on the market value of the properties. The rate is determined by the average value of the properties, subject to a minimum of 1%.

5.2 Part shares / part cash

As commented at the start of this section (see 5b above), s162 allows that not all the consideration need be in shares. In this scenario a proportion of the gains on the transfer of assets is held over equal to the ratio between the value of the shares and the total value of the consideration (i.e. shares plus cash).

By this means some loan account can be created whilst still increasing the base cost of assets to full market value.

This would be useful, taking the example of the farmer above, where he wished for some cash for personal use whilst retaining some cash in the company.

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6. A cash subscription for shares followed by a sale of assets at full value

The steps to implement this route are

a. A company is set up with only a single subscriber share that is not paid up.
b. The individual subscribes for additional shares in cash (also paying up the subscriber share).
c. The business assets are sold to the company at full market value.

The gain on the assets is deferred under the provisions of TCGA 1992 Sch 5B (Enterprise Investment Scheme: Re-investment).

This route combines some of the advantages of the first two routes. It has the flexibility of the first route including the ability to create a loan account whilst allowing the company to acquire assets at full market value without necessarily triggering an immediate capital gains tax charge.

In particular, as with option 1 but not 2, there is the choice whether to put the property in or not. However, if there is an intention to sell part or all of the property then obviously it needs to be included to gain the step up in tax base cost.

The main disadvantage is that it requires compliance with the Enterprise Investment Scheme rules.

6.1 Size of share subscription

There is flexibility in the size of the share subscription.

For example, a sole trader business has the following assets:

Goodwill	£200,000 (cost nil)
Net current assets	£100,000
Property	£400,000 (cost £250,000)

If both the goodwill and property are to be sold at full market value, a share subscription of £350,000 is sufficient to defer the gains on both the goodwill and property in full. This leaves a loan account of £350,000, i.e. equal to the value of the non-chargeable net assets and the base cost of the property.

The share subscription could be reduced by £10,600 to allow the use of the capital gains tax annual exemption. It could be further reduced if, for example, the individual has capital losses available. Alternatively one might prefer to accept some capital gains tax cost now at a rate of 10% in order to create a larger loan account for later use.

This contrasts with the s162 incorporation where creating a loan account of £350,000 would mean that half of the capital gains would be chargeable.

6.2 Enterprise Investment Scheme rules

As is often the case with any tax relief, the EIS rules are hedged around with a number of often complex provisions that can easily catch out the unwary. The comments below cover the rules that are most likely to cause problems, if not careful, but are not intended to be an exhaustive treatment.

It should be noted that there are two other two reliefs associated with EIS investments. These are 20% income tax relief on investment and capital gains tax exemption on a later sale. Both of these reliefs require that the investor is not connected with the company. Connection includes owning more than 30% of the share capital. This rule does not apply to capital gains tax deferral. Thus normally in an incorporation situation the other two reliefs will not be available. However, for example, if the business is owned 25% each by four otherwise unconnected individuals, obtaining these extra reliefs is possible. Further consideration of this is beyond the scope of this report.

References are to TCGA 1992 Sch 5B unless otherwise stated

i. Nature of the trade

The company must be trading, so this cannot be used for a property letting business, and its trade must not be one of the "excluded activities" listed in ITA 2007 s192. Note that furnished holiday letting, deemed to be a trade for some purposes, is not a trade for EIS purposes.

Excluded activities are

(a) dealing in land, in commodities or futures or in shares, securities or other financial instruments,
(b) dealing in goods otherwise than in the course of an ordinary trade of wholesale or retail distribution,
(c) banking, insurance, money-lending, debt-factoring, hire-purchase financing or other financial activities,
(d) leasing (including letting ships on charter or other assets on hire),
(e) receiving royalties or licence fees,
(f) providing legal or accountancy services,
(g) property development,
(h) farming or market gardening,
(i) holding, managing or occupying woodlands, any other forestry activities or timber production,
(j) shipbuilding,
(k) producing coal,
(l) producing steel,
(m) operating or managing hotels or comparable establishments or managing property used as an hotel or comparable establishment,
(n) operating or managing nursing homes or residential care homes or managing property used as a nursing home or residential care home, and
(o) any activities which are excluded activities under section 199 (provision of services or facilities for another business).

As can be seen, it excludes a lot of activities where property is a major part of the trade, such as farming and hotel operation.

ii. Subscribe in cash

The rules [para 1(2)(aza)] require a subscription in **cash**. This cannot be overemphasised as HMRC enforce it almost to the letter (the transfer can be electronic or by cheque – bank notes are not required!). Unless the individual has substantial free cash, it will mean that he must borrow from a third party such as a bank, the cash then goes into the company bank account as a share subscription, comes back to the individual as payment for the business assets and then the individual can repay the loan. Book entries are not sufficient. HMRC may ask for evidence of the cash trail.

iii. Cap

The maximum share investment in any 12 month period is £2m.

iv. Using the cash

The cash raised by the share subscription must be used within two years. Normally this is not an issue as all the cash will be used to buy the assets of the old business.

v. Value received

If the investor receives "value" (other than "insignificant value") from the company during a period from one year before to three years after the date of investment, **all** the relief is lost.

The meaning of value received is found in paras 13 to 14A.

The first key section is found in para 13(2), which says that an individual receives value from the company if the company–

(a) repays, redeems or repurchases any of its share capital or securities which belong to the individual or makes any payment to him for giving up his right to any of the company's share capital or any security on its cancellation or extinguishment;
(b) repays, in pursuance of any arrangements for or in connection with the acquisition of the shares, any debt owed to the individual other than a debt which was incurred by the company–
    (i) on or after the date of issue of the shares; and
    (ii) otherwise than in consideration of the extinguishment of a debt incurred before that date;
(c) makes to the individual any payment for giving up his right to any debt on its extinguishment;
(d) releases or waives any liability of the individual to the company or discharges, or undertakes to discharge, any liability of his to a third person;
(e) makes a loan or advance to the individual which has not been repaid in full before the issue of the shares;
(f) provides a benefit or facility for the individual;
(g) disposes of an asset to the individual for no consideration or for a consideration which is or the value of which is less than the market value of the asset;

(h) acquires an asset from the individual for a consideration which is or the value of which is more than the market value of the asset; or
(i) makes any payment to the individual other than a qualifying payment.

Qualifying payment (see (i) above) is defined in para 13(7) as

(a) the payment by any company of such remuneration for service as an officer or employee of that company as may be reasonable in relation to the duties of that office or employment;
(b) any payment or reimbursement by any company of travelling or other expenses wholly, exclusively and necessarily incurred by the individual to whom the payment is made in the performance of duties as an officer or employee of that company;
(c) the payment by any company of any interest which represents no more than a reasonable commercial return on money lent to that company;
(d) the payment by any company of any dividend or other distribution which does not exceed a normal return on any investment in shares in or other securities of that company;
(e) any payment for the supply of goods which does not exceed their market value;
(f) any payment for the acquisition of an asset which does not exceed its market value;
(g) the payment by any company, as rent for any property occupied by the company, of an amount not exceeding a reasonable and commercial rent for the property;
(h) any reasonable and necessary remuneration which–
    (i) is paid by any company for services rendered to that company in the course of a trade or profession carried on wholly or partly in the United Kingdom; and
    (ii) is taken into account in calculating for tax purposes the profits of that trade or profession;
(i) a payment in discharge of an ordinary trade debt.

It is important to be familiar with these and ensuring that the client is made aware of them at least in broad terms.

It is worth noting that any loan arising on purchase of the business can be repaid as this was created after the share subscription. However, any loan created before the share subscription (and this would probably only happen if an existing company rather than a new company is used for the incorporation) cannot be repaid. In this situation, it would be important to keep the two loans separate.

Dividends can be paid and HMRC’s general view is that any dividend paid to all shareholders is accepted as normal. However, beware using dividend waivers or different classes of share to allow different rates of dividend as these could be challenged.

COMPLIANCE ISSUES

1. Operating as a company

It is assumed that the practitioner is familiar with the requirements of operating a company and so no further comments will be made.

2. Incorporation using TCGA 1992 s165

Where assets are being sold to a company at less than full market value, it is necessary to elect to hold over all or part (depending on actual consideration) of the capital gain.

The holdover election is made by completing Helpsheet 295 obtainable from HMRC at http://www.hmrc.gov.uk/helpsheets/hs295.pdf.

3. Transferring stock at less than market value

If stock is sold to a company at less than full market value (see 4.1ii above) it is necessary to make an election under ITTOIA 2005 s178. There is currently no prescribed form to do this and so it is recommended that a note is made (including the statutory reference) in the white space of the Self Employment pages of the sole trader's tax return and in the tax computations of the company attached to its CT600 return.

4. Incorporation using TCGA s162

Section 162 applies automatically and so no election is required.

5. Incorporation using Enterprise Investment Scheme

The procedure for claiming EIS deferral relief is more complex.

Once the share subscription has been made, the company must complete a form EIS1 (downloadable at http://www.hmrc.gov.uk/forms/eis1.pdf). This must be completed no sooner than four months after the trade has commenced and no later than two years after the completion of that four month period. The form is not submitted to the local HMRC office but to a specialist unit (address is on the form).

Once HMRC is satisfied that the company complies with the EIS rules, it will send a form EIS2 to the company which authorises it to issue forms EIS3 (blank ones supplied with the EIS2) to the shareholders.

The shareholder completes the claim form attached to the EIS3 and submits this to HMRC attached to the Capital Gains summary of his tax return. Quoting from page 5 of HMRC Helpsheet HS297
(http://www.hmrc.gov.uk/helpsheets/hs297.pdf).

"If the gain(s) against which you are claiming deferral relief arose in the tax year to which this return relates, please put 'X' in box 26 on page CG 2 and provide details of the claim in the 'Any other information' box, box 35, or in your computation, providing a clear statement that EIS deferral relief is being claimed."

APPENDIX 1

The example below illustrates the difference in post-tax income to an individual earning £40,000 operating as

1. A company paying a small salary and the balance of post-tax profit as dividend
2. A company paying the whole profit as salary.
3. A sole trader.

The example is based on 2011/12 tax rates.

		Dividend	Salary	Sole trader
Company				
Profit before tax		40,000	40,000	
Salary		-7,072	-36,007	
Employer's NIC on salary	13.8%	0	-3,993	
Net profit		32,928	0	
Corporation tax		-6,586	0	
Profit after tax		26,342	0	
Dividend		-26,342		
Retained profit		0	0	
Individual				
Profit				40,000
Salary		7,072	36,007	
Dividend		26,342		
Add: Tax credit	10%	2,927		
Gross income		36,341	36,007	40,000
Less: Income tax		-2,927	-5,706	-6,505
Less: National insurance		0	-3,454	-3,080
Net income		33,414	26,847	30,415
Advantage of dividend			**6,568**	**2,999**