



Incorporation

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Summary

Introduction

According to official statistics, the UK private sector currently comprises some 3.8 million business enterprises. Of these, around 1.8 million are limited companies, the bulk of the rest being sole traders or partnerships.

As these figures suggest, the decision on how to structure a business is not a clear-cut one. There are advantages and disadvantages to being a company, on the one hand, and a partnership or a sole trader on the other. Different people will have different ideas about what factors are especially advantageous or disadvantageous to them and about what weight should be attached to the different factors.

Changes to the tax system announced in the 2002 Budget were widely seen as having pushed the balance of advantage firmly in favour of incorporation, although subsequent action by government and the tax authorities have caused many smaller businesses to think again. Significant though fiscal incentives might seem in themselves, they should not be looked at in isolation or seen as the single, decisive variable in any decision to incorporate.

This booklet is aimed at business people who wish to consider the merits of incorporating a new or existing business. It discusses a range of matters which should be taken into account in any decision

on whether or not to incorporate.

Hopefully, it will give the reader useful information on the pros and cons of adopting corporate status. Before making any final decision on incorporation, however, you are strongly advised to talk your requirements through with your accountant.

The business options

UNINCORPORATED BUSINESSES VS CORPORATIONS

An “unincorporated” business is any business which has not adopted formal corporate status, i.e. as either a limited company or a limited liability partnership. Unincorporated businesses may be either sole traders or partnerships.

If you are trading as a **sole trader**, you are personally responsible for your business activities. You may take all the profits made by the business, but at the same time you are responsible for all its debts and liabilities. You are taxed on a self-employed basis on your total personal income, from your business and any other source.

The **partnership** is the main non-corporate vehicle by which individuals conduct business on a joint basis. Contrary to common belief, a “partnership” does not actually exist as a legal entity in its own right: technically, a partnership is only the amalgam of the individual partners who make up the partnership. When a partnership conducts business, it does so through its individual partners, not as a collective entity. Each partner acts as an agent not of the partnership as an entity but of his or her fellow partners, which means in effect that each partner is bound by the actions of those other partners. Partners are also jointly and severally liable for their firm’s debts.

The partnership is a very private, flexible format which allows individual firms to decide for themselves how to organise their internal governance, management and profit-sharing arrangements. Partnership has always been, and still is, popular with professional firms, but is also widespread among businesses of all kinds.

Given that partners are personally liable for their firm’s debts, there are no public disclosure requirements. Individual partners are taxed on their personal income from the partnership as if they were self-employed.

A little-known and little-used alternative form of the partnership

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is the **limited partnership** (not to be confused with the limited liability partnership - see later). The limited partnership is like a partnership proper but it allows one or more partners in the firm to limit their personal liability for the firm's debts. The price to be paid for this limitation of liability is that the limited partner may not take part in the management of the firm. The limited partnership may therefore be a useful format for use in situations where a number of parties wish to undertake a particular business project together in a discreet, non-public manner but where one or more parties is unable or unwilling to get involved in the operational management of the venture. The number of limited partnerships in the UK is currently

thought to be less than 10,000.

WHAT DOES INCORPORATION MEAN IN PRACTICE?

The term incorporation refers to the process whereby a brand new business, or an existing business which is carried on by individuals in partnership or in their own names, is converted into a corporate body. Usually, this means registering the business as a limited company by means of a standard registration process.

The significance of incorporation is that the new company becomes what is known as a "legal person" in its own right. This has two important practical consequences. First, from the moment of incorporation the company is

treated as a separate entity from the individuals who control the company as its shareholders and directors. The assets and liabilities of the company are, as a rule, the responsibility of the company itself and not the individual shareholders or directors, even where the company has just one shareholder/director who is plainly the guiding force behind the company's activities. Further, any legal action by an aggrieved customer or client of the company, or a third party, has to be taken against the company rather than against its shareholders or directors.

The second main consequence of incorporation is that the company's existence continues independently of the identity of its shareholders

and directors. Where a person carries on a business in his or her own name, then the retirement or death of that person brings the business to an end. Under current partnership law, each change of partner, for whatever reason, technically brings the partnership to an end, and the re-constituted partnership survives only until the next change of partner. In the case of a company, shareholders are generally free to sell their shares if they wish to do so. Even when there is a complete change of ownership, for example, where the company is taken over by another business or where a sole shareholder dies, the company survives. Therefore, the company format allows a business to be

planned for the long term. Additionally, the shareholders in a limited company enjoy limited personal liability for the debts of their company. Unless they act additionally as directors, shareholders have no personal responsibility for the debts of their company in the normal course of trading. In the case of a company limited by shares, the liability of each member is limited to the amount, if any, which is unpaid on his or her shares in the event of the company's winding up. So if the company goes into liquidation because it cannot pay its debts, its shareholders will be required, at most, to pay to the liquidator whatever amounts remain unpaid on their shares.

Against this, though, shareholders bear the ultimate risk in a company, in the sense that, if their company fails, they stand to lose whatever amounts they have invested in their company. In any winding up, shareholders will only see a return if there are still assets available after all the creditors have been paid. Accordingly, if a company is wound up on an insolvent basis, shareholders can expect to lose the entire value of their investment. It should also be borne in mind that banks and other lenders of finance will usually insist, as a condition of agreeing to lend funds to a small company, that its director or directors give personal guarantees that the loan will be repaid. Any company which

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expects to have to borrow substantial funds in its early years should be aware of this factor, which has the effect of diluting, for many small company director/ shareholders, the value of limited liability.

Once you have completed the registration formalities and your new company has satisfied Companies House that the registration requirements have been fulfilled, you will receive a certificate of incorporation. This will set out important information concerning the existence of the company, including its name, its registration number and its date of incorporation, i.e. the date on which the company came into legal

existence. Once the certificate has been received, a private company may commence trading immediately. (A public company cannot begin trading until it has acquired a separate trading certificate from Companies House.)

HOW MANY TYPES OF COMPANY ARE THERE?

Companies House may accept for registration new companies of the following kinds:

- i) private company limited by shares
- ii) private company limited by guarantee
- iii) public company limited by shares
- iv) unlimited company.

- i) Private company limited by shares

This is by far the most popular form of company: this booklet in fact assumes that the private company limited by shares will be the preferred option for those who wish to incorporate their businesses. It requires little in the way of capital commitment, enables present and future shareholders to dispose of their interests as they see fit, and restricts the liability of each shareholder to the amount owing on their shares at the time of the company's liquidation. The "private" element in the name of the format means only that shares in a private company may not be put on open sale to the public.

Despite this restriction on raising funds through the issue of shares, a private company, like other types of company, can provide valuable security for loans by the granting of a floating charge over its assets: this option is not available to unincorporated entities.

ii) Private company limited by guarantee

"Guarantee" companies are popular with non-profit-making entities, such as clubs and charities. The format allows the entity concerned to take advantage of separate legal personality and perpetual existence without providing any means whereby individual members might receive a share of profits or sell their membership rights. The

"members" in a guarantee company are members in the general sense of the word, and their liability for the company's debts is restricted to the amount, usually a very nominal amount, that they agree to pay in the event of the company's liquidation.

iii) Public company limited by shares

This format differs from the private company limited by shares in that it is legally entitled to raise funds by offering its shares direct to the public. In consequence of this, however, the public company must comply with more stringent formation and disclosure rules. On incorporation, it must have an "authorised share capital", i.e. an

upper limit on the amount of shares it proposes to issue, of at least £50,000. Before it can begin trading, it also has to have a certificate of trading issued by Companies House. This will only be given if at least 25% of the authorised share capital has actually been paid up by the new company's shareholders. A public company can be struck off the register if it does not apply for a trading certificate within a year of its incorporation.

iv) Unlimited companies

Unlimited companies are all "private". They are corporate bodies, and thus enjoy separate legal personality, but as the name implies, their members have

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unlimited liability for their company's debts in the event of the company's liquidation. The main advantage of the unlimited company is that, as long as it is not owned by another limited company and does not itself own any limited companies, it is not required to file annual accounts with Companies House.

THE LIMITED LIABILITY PARTNERSHIP

Since April 2001, an additional option has been available to businesses which are contemplating incorporation. This is the Limited Liability Partnership, known as the LLP for short. This new type of entity is a corporate body, just like a limited company, but as its name

implies, it is designed to be a "half-way house" between the company format and the partnership format. As such, it embodies characteristics of both those other formats, as summarised below.

The LLP resembles a company in that:

- it is a corporate body
- it has separate legal personality
- it is required to comply with many provisions of companies legislation
- the liability of its members may be limited.

The LLP resembles a partnership in that:

- its members are free to determine the internal management and administration arrangements of the firm
- unless otherwise agreed, all members are entitled to participate in the management of the firm
- each LLP must have at least two members
- each member is taxed on his or her own income from the firm (as if they were self-employed).

For detailed information on the LLP, readers are directed to ACCA's information booklet on the LLP, which is available from the ACCA web site (www.accaglobal.com/publications).

The consequences of incorporation

HOW EASY IS IT TO FORM A COMPANY?

Until 1992, it was necessary for all companies, private and public, to have a minimum of two members. Since then, it has been possible to form private companies with only one member.

Accordingly, a self-employed businessman or tradesman, e.g. John Smith, may now incorporate his business (as, e.g., John Smith Ltd) and trade as a limited company. Moreover, there is no minimum capital requirement for a private company, so one person can form a company with a share capital of just £1.

The registration process involves filing the following documents:

- the company's Memorandum of Association
- the company's Articles of Association
- a pro-forma statement (Form 10) which includes details of the first directors and secretary of the company and the intended situation of the company's registered office; and
- a statutory declaration (Form 12) to the effect that all the registration formalities have been complied with.

These documents must be returned to Companies House. The Memorandum should contain core information regarding the company's identity, including its name, its type, its country of incorporation and its objects. The Articles contain procedural rules regarding, e.g. the appointment of directors and arrangements for holding general meetings.

Model versions of the Memorandum and Articles are set out in regulations made under the Companies Act. Rather than draft their own constitutional documents themselves, many companies decide simply to adopt the model Articles either in their entirety or with a small number of amendments.

WHAT DOES IT COST TO FORM AND MAINTAIN A COMPANY?

The cost of formation is modest. The principal cost is an initial registration fee, which is currently set at £20 (or £50 for same-day registration). If you enlist the assistance of a solicitor to help you comply with the registration formalities, you will obviously incur additional professional costs. As an alternative to compiling the various forms yourself, you may approach a company formation agency. Agencies can either present you with a pre-registered company (often referred to as an “off-the-shelf” company) or they can register a brand new company in accordance with your express instructions, e.g. regarding the company’s desired name, objects or date of registration.

Once incorporated, a company is required to comply with a range of statutory obligations under the Companies Act, some of which will involve expense and some will not. The two requirements which will almost certainly involve new private companies in expense involve the preparation and filing of the Annual Return and the company’s annual accounts.

The **Annual Return** is a statutory document which contains information on the company’s directors, shareholders and share capital. It is designed to ensure that this information, which is put on the public record, is kept up to date. The compliance cost of the Return to businesses is minimal, since Companies House distributes a pre-

printed form to each company shortly before the next Return is due to be filed; companies merely have to check whether or not the information on the pre-printed form is still valid, insert any changes, and return the form to Companies House. The filing fee for the Return is currently £30 (or £15 if you file on time).

Annual accounts are the responsibility of a company’s directors and must be filed by all limited companies. Currently, the filing deadline for the accounts of private companies is ten months from the accounting year end. Accounts have to contain all the information required by the Companies Act and by technical standards laid down by the

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Accounting Standards Board (ASB): these include Financial Reporting Standards (FRSs) and Statements of Recommended Practice (SORPs). Where, however, a company qualifies as 'small' it may choose to comply only with the ASB's Financial Reporting Standard for Small Entities (FRSSE), rather than with the full collection of ASB standards and guidance. In order to qualify as 'small' for this purpose, a company must meet two of the following three tests, in both the current financial year and the preceding one:

- its turnover must not exceed £5.6m
- its balance sheet total must not exceed £2.8m

- it must not have more than 50 employees

Unless a company has a director or an employee who is a qualified accountant, it is highly unlikely that it will be able to prepare its accounts in accordance with the required standards without the help of an independent accountant. The fees for preparing accounts on directors' behalf will depend on the size and complexity of the company.

As well as preparing annual accounts, a company may be required by law to have those accounts audited. This is a separate process by which an auditor checks whether a set of accounts has been properly

prepared in accordance with the disclosure requirements of the Companies Act and also gives what the Act calls a "true and fair view". The Companies Act exempts most private companies which qualify as "small" – as defined above - from the otherwise standard requirement for annual statutory accounts to be audited.

If a company qualifies for audit exemption, therefore, it is free to file its annual accounts with Companies House without an audit report attached to them. Directors of small companies are, however, advised to think carefully before they decide to dispense with an audit. The extra cost of the audit, over and above the cost of actually preparing the accounts, is likely to

be modest. And whatever the law says, in many cases small companies will need to have their accounts audited since banks and other finance providers will invariably insist on seeing audited accounts before they will consider lending money to them. The audit also offers a practical benefit to companies in that the auditor, as a standard part of the audit function, will look out for weaknesses or inefficiencies in the company's record-keeping and control systems and, where he thinks it would be helpful for the company for him to do so, will make recommendations for improvements.

One other Companies Act obligation in regard to which a new company may incur voluntary

expense concerns the post of company secretary. Under current legislation, all companies must have a company secretary, although in the case of private companies, the secretary need not possess any specific qualification. Some private companies find it useful to enlist, on a consultancy basis, the input of a person who is qualified or experienced in company administration to guide them in complying with their responsibilities and to avoid disputes arising. Note that a sole director may not simultaneously act as the company secretary of the same company.

HOW MUCH EXTRA ADMINISTRATION DOES CORPORATE STATUS BRING?

The Companies Act requires companies, via their directors, to abide by a number of rules regarding their internal administration. For example, they are required to keep minutes of all their board and general meetings, to keep up-to-date registers of members, and to observe standard procedures when administering share transfers. They also have to ensure that prescribed information is displayed on their business stationery and outside their business premises, so as to inform all customers, prospective customers and the general public of their corporate status.

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The above notwithstanding, the administrative obligations of private companies has been streamlined greatly in recent years. Private companies can now opt out of the statutory requirements to hold an AGM and to present their accounts to shareholders at a general meeting. They can also pass company resolutions in writing, rather than going through the formality of holding a general meeting to do so. It is likely that the trend of the past decade or so, in favour of the lighter regulation of private companies, will continue.

WHAT DOES IT MEAN TO BE A DIRECTOR?

Every private company must have at least one director. Directors are the officers who control and

manage the company's affairs on behalf of the shareholders. It is they who usually have the power to take all or most of the important decisions regarding the running of their companies. Because they have authority to handle the funds and control the operations of what is technically a third party, i.e. their company, the law ascribes to directors a "fiduciary duty" to their company – this is similar to the duty owed by a trustee to his beneficiary. It means, essentially, that directors owe to their company a duty of skill and care, they must act in good faith when carrying out their duties, and they must put the interests of their company above their own personal interests.

The Companies Act imposes a

number of specific obligations on company directors, such as responsibilities to prepare annual accounts and to keep accounting records. These statutory obligations all derive from the fiduciary responsibilities that they owe to their company under the common law. Failure to comply very often means that both the company and the individual directors commit an offence and are liable to prosecution. It should also be noted that, while directors' duties are usually owed to their company, meaning the body of its shareholders, the situation changes somewhat when the company is insolvent or is facing insolvency. At this point the directors are accountable to the company's creditors. Failure to take

appropriate action to protect creditors' interests when the company is faced with impending insolvency may lead to directors being made personally liable for their company's debts.

It is advisable that those who are contemplating becoming a director as the result of the incorporation of their business familiarise themselves with the range of duties to which they would be subject as directors. This is all the more important since it is likely that the laws on directors' duties will be tightened significantly as the result of new legislation likely to be introduced in the near future.

HOW EASY IS IT TO WITHDRAW MONEY FROM A COMPANY?

Where a person conducts business

under his or her own name, that person is free to use the funds of the business as he or she sees fit. There are no restrictions as to how much of the firm's profits can be taken, or how often withdrawals may be made. The proprietor will be restricted only by the practical need to ensure that the business remains in funds so as to continue in operation. In the case of a partnership, the rules governing withdrawal of profits and funds will be dealt with by each individual firm's in-house partnership agreement.

Since, however, the company is a separate legal entity, and its assets belong to it and not to its individual members, companies are restricted in the ways in which they may

distribute funds to their directors and shareholders. The Companies Act therefore contains rules which are designed to reinforce the company's special status and to prevent the company's funds from being withdrawn other than in specially authorised circumstances. These circumstances can be divided into two main headings: distributions of profits and loans.

Distribution of profits

When a company records a profit in its annual accounts, it is entitled, through its directors, to return all or part of that profit to its shareholders by way of a dividend. In making any decision on dividends, the directors must assess, by reference to the most recent annual accounts and any

previous sets of accounts, whether the company has what are termed "net realised profits". This term means that a company must have a surplus of accumulated 'realised' profits over accumulated 'realised' losses before it can think about making a distribution. If director/ shareholders make a distribution to themselves, when their company does not have net realised profits, they are liable to repay the amount of the dividend to their company. The rules governing realised profits and losses are complicated and decisions should not be made without expert advice from an accountant.

Loans

There is a basic restriction on companies making loans to their

directors or providing any guarantee or security for the taking out of a loan by one of them. This restriction applies to both private and public companies. There are, however, two principal exceptions to the rule. First, there are no restrictions on a company making a loan or loans to a director if the aggregate of such loans does not exceed a specified level, which is currently £5,000. Second, companies may make loans to directors to enable them to meet expenditure already incurred by them, or to be incurred by them, for company purposes. In this latter case, though, the loan must either be approved in advance at a general meeting, or, if the loan is not approved by or at the next AGM, it must be repaid in full

within six months of the date of that meeting.

SHOULD COMPANIES COMPLY WITH THE NATIONAL MINIMUM WAGE?

All businesses, whether they are incorporated or not, are covered by the minimum wage rules if they employ staff. All businesses which are covered are, therefore, required to pay (at least) the statutory minimum wage and to comply with the associated administrative formalities, which are fairly extensive.

When it comes to company directors, the position becomes slightly complicated. Directors are not, solely by virtue of their office, "employees" of their company. In

employment law, an “employee” is regarded, broadly speaking, as a person who is hired by an employer to carry out a specified function under specified terms and conditions.

Directors do not automatically come into this category, since they usually have powers and responsibilities to manage the whole of their company’s operations without restriction. They will, however, be regarded as employees if they have a contract of employment with their company, written or unwritten, which creates an employment relationship. In larger companies, many companies give their directors service contracts and give them specific responsibilities, e.g. as finance

director or sales director: directors in this position will be employees under the law.

The actual term used in the minimum wage regulations to govern who is covered by the minimum wage regulations is not “employee” but “worker”. This is defined as a person who is working under a contract of employment – this means an employee – or “some other form of contract under which he agrees to perform work for someone else but is not self-employed”. The DTI and the Inland Revenue have agreed that, if there is no written contract of employment or other evidence of an intention to create an employer/worker relationship, they will not seek to argue that there is any

unwritten employment relationship between the director and his company.

Therefore, if a company wishes to avoid all doubt about whether or not it needs to comply with the minimum wage rules in respect of any of its directors, it should ensure that it does not give the Inland Revenue any encouragement to believe that there has been any intention to create any such relationship.

The tax implications

HOW ARE COMPANIES TAXED?

Companies are subject to a wholly different taxation regime from sole traders and partnerships, with both the latter being treated as if their proprietors and partners are self-employed. The different basis reflects the fact that companies are separate legal entities from the individuals who own and control them. Companies, along with certain other types of entity, including members' clubs, trade associations, housing associations and co-operatives, are subject to corporation tax rather than income tax.

Each company, once incorporated, is required to inform the Inland Revenue that it exists and is liable for corporation tax. Payment is in due course calculated and paid by

a process of self-assessment. This means that companies calculate their liability themselves, by reference to the prevailing rate of corporation tax and after taking into account applicable allowances and deductible expenses. They must then pay their tax direct to the Inland Revenue: this must be done within nine months and a day after the end of the accounting period. Companies are liable to financial penalties if they fail to deliver a self-assessment return (on form CT 600) and accounts by the statutory filing date, which is 12 months after the end of the relevant accounting period. So, for example, if a company prepares its annual accounts up to 31 December 2004, it must file its self-assessment return and pay its tax

by 31 December 2005. For the tax year 2004–5, the tax rates are as follows:

	Taxable profits (£)
Starting rate (0%)	0–10,000
Marginal relief	10,001–50,000
Small companies' rate (19%)	50,001–300,000
Marginal relief	300,001–1,500,000
Main rate (30%)	1,500,000+

The two rates of marginal relief apply where taxable profits exceed the relevant lower level but fall below the higher level. The applicable rate in these circumstances is determined by using a set formula, which includes a special fraction for use in the calculation. The formula is, for information, as follows:

$$\text{Marginal rate fraction} \times (\text{relevant upper threshold} - \text{"profits"}) \times (\text{"basic profits"} / \text{"profits"})$$

The marginal rate fractions are 19/400 for the first marginal rate and 11/400 for the second. The resulting figure is subtracted from the tax that would have been levied on the company's profits at the higher rate in order to arrive at

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the actual tax payable (NB marginal relief must be expressly claimed on the company's self-assessment return).

The calculation is demonstrated in the following simplified examples.

Example 1

A company makes total taxable profits of £45,000. The calculation would be:

	£
Corporation tax @ 19% on £45,000	8,550
minus marginal relief $19/400 \times (50,000 - 45,000)$	(238)
Corporation tax payable	8,312

Example 2

A company makes chargeable profits of £750,000 and also receives £100,000 of dividend income (known as franked investment income).

The calculation in this case is as follows:

	£
Corporation tax @ 30% on £750,000	225,000
Minus marginal relief $11/400 \times (1,500,000 - 850,000) \times 750,000/850,000$	(15,772)
Corporation tax payable	209,228

NATIONAL INSURANCE CONTRIBUTIONS (NICS)

The self-employed, as well as partners in partnerships, pay Class 2 NICs on earnings above £91pw. The rate of Class 2 contributions in 2004-05 is £2.05 pw. In addition, they pay Class 4 NICs in respect of trading profits. The rate of Class 4 contributions is 8% on profits falling between the lower annual earnings limit (£4,745 in 2004-05) and the upper limit (£31,720) and 1% on profits above the upper limit.

Companies are required to pay Class 1 National Insurance contributions – known as “primary” Class 1 contributions – on the remuneration they pay to their directors. (Directors in turn are required to pay employees’

NIC contributions – termed “secondary” Class 1 contributions – on their own income between the lower limit and the upper limit.) For

the tax year 2004–05, the rates of employer’s and employees’ Class 1 contributions for non-contracted out employment are as follows:

Earnings limits	Employees’ contribution	Employer’s contribution
Below £79 weekly	No NICs payable	No NICs payable
£79 to £91 weekly	0%	0%
£91.01 to £610 weekly	11%	12.8% on all earnings above the ET
Over £610 weekly	1%	12.8% on all earnings above the ET

(ET stands for the earnings threshold, which is currently £91pw/£395pm/£4,745pa).

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HOW ARE DIRECTORS' EARNINGS TREATED?

Companies are required by the Companies Act and the Taxes Act to deduct tax from all remuneration paid to their directors. In most cases, remuneration is chargeable to income tax under Schedule E: this is the case whether or not the director is regarded as being an "employee" under employment law. Accordingly, whether the director's remuneration is paid as a salary or a one-off fee, Schedule E income tax is deductible from that payment; by virtue of being liable to Schedule E, Class 1 NICs are also payable, by both the "employer" (the company) and the director.

A form P11D (giving details of benefits in kind) must be prepared

by the company for all directors, even where their earnings fall below the standard P11D threshold of £8,500. Each director will have to file their own self-assessment income tax form separately.

WHAT IS "IR35"?

What is widely referred to as the "IR35" rule is in fact a provision in the Finance Act 2000 which is designed to prevent individuals acting through limited companies in order to take advantage of the perceived tax and NIC benefits of doing so. By the late 1990s, it had become common practice for individuals, particularly those working in industries such as information technology, to set themselves up as one-person

limited companies – or "personal service companies" – and to present their services to companies in a consultancy capacity.

The practice became widespread and the Inland Revenue became concerned that, in many cases, individuals were claiming to be acting as consultants to companies when the circumstances of their involvement with the companies concerned suggested that they were more like employees than consultants. In short, the Inland Revenue suspected that individuals were using the company format as a device to minimise their own tax liability and at the same time to free companies of their obligations to deduct and pay over PAYE and NICs.

So the IR35 rules were enacted in the Finance Act 2000. After a long legal battle by supporters of the personal service company concept, the validity of the rules were confirmed by the High Court in December 2001. IR35 does not prevent people forming such companies, but ensures that, where certain conditions are fulfilled, the companies concerned are taxed as if the individuals behind them were employees.

For a company to be caught by IR35, the following conditions must be met:

- the individual must personally perform, or be under an obligation to perform, services for the client

- the individual must have a “material interest” in the company (this means, essentially, beneficial ownership of more than 5% of the company’s share capital)
- the company must receive payment or payment in kind for the services performed by the individual
- the circumstances must be such that the worker would have been an employee of the client if hired directly rather than through the company.

Where a company is caught by the above conditions, monies received by the company from the client in respect of services performed by

the client are taxed as Schedule E rather than trading income. There will also be a NIC liability. Details of how such payments are taxed are set out in an Inland Revenue booklet *How to Calculate the Deemed Payment* (IR 2003) which is available from the Inland Revenue web site at www.inlandrevenue.gov.uk

IS IT MORE TAX-EFFICIENT TO INCORPORATE?

Whether or not incorporation is tax-efficient in the case of an individual business should be considered by reference to all the following factors:

- the applicable rate of corporation tax as opposed to income tax

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- the comparative rates of NIC contributions
- the capital gains tax charges on assets sold by the company.

The current rates of corporation tax have been set out above. These should be compared with the corresponding rates of income tax, which are, for 2004–05:

	£
Starting rate (10%)	0–2,020
Basic rate (22%)	2,021–31,400
Higher rate (40%)	31,400+

Comparison of the rates of corporation tax and income tax shows that higher rates become payable at far lower levels of income under income tax than corporation tax. A person earning £32,000 a year as an employee or as a self-employed person will have started paying 40% tax on their income, while a company making taxable profits of £32,000 will be paying less than 19% in corporation tax.

As has been indicated already, NIC levels are high for company director/employees vis-à-vis sole traders and partners. The differentiation in this respect as between companies and unincorporated entities has been

exacerbated by the change first announced in the 2002 Budget which means that employees' Class 1 contributions are now payable on all their earnings above the lower earnings limit.

While the higher NIC rates are, on the surface, a disincentive to incorporate, it may be possible and legal for companies to arrange the way that they pay their directors so as to take maximum advantage of both tax rates and NIC levels. This can be done by paying directors either a low level of basic remuneration (subject to any applicable minimum wage obligation) or even none at all, and paying them a comparatively high level of dividend - remembering,

again, the Companies Act rules governing distributable profits, referred to earlier. (But see the passage below headed 'Husband and Wife companies').

Where the incorporation decision involves only one or two director/ shareholders in the company, it may be possible to draw up a direct comparison between their position as proprietors of an unincorporated business and the situation they would be in if their business were a company.

As a highly simplified example, assume that two businesses, a sole trader and a single-member company, have made identical profits, in 2004–05, of £31,400.

First of all, consider the position of the sole trader.

	£
Profits	31,400
Less personal allowance	(4,745)
Chargeable income	26,655
Income tax	(5,621.70)
made up of first 2020 @10% = 202 and next 24,635 @22% = 5,419.70. Total 5,621.70	
Class 2 NICs	(106.60)
Class 4 NICs	(2,132.40)
	(7,860.70)
Leaving	18,794.30

SECTION 3

The position of the company would be as follows:

	£
Profits	31,400
Less directors' remuneration	(4,745)
Employer's Class 1 NICs	(nil)
	26,655
Corporation tax	(3,830.65)
First 10,000 @ nil rate, next 16,655 @ 23.75% (marginal rate) = 3,830.65 Total 3,830.65	
Leaving	22,824.35

There is thus a hypothetical tax gain at this level of profit, as against the sole trader scenario, of £4,883.15.

The director/shareholder's own position would be:

Remuneration	4,745
Less personal allowance	(4,745)
PAYE liability	nil
Employee's 1 NICs	nil

The company example assumes that the company would pay its director/shareholder a level of remuneration which is low enough to escape PAYE and NIC liability, and would make up for this by paying a high proportion of its profits to the director/shareholder by way of dividend. It also assumes no other source of income, including Schedule E income.

Note, though, that with respect to distributions made after 31 March 2004, a special rate of tax, the 'non-corporate distribution rate', is imposed where a company which has an 'underlying rate' of corporation tax that is less than 19% makes a distribution to a non-corporate shareholder.

As an example, take a company which makes taxable profits of £9,000, thus qualifying for the 0% underlying rate. If it pays all or some of its profits as dividends to its individual shareholder or shareholders, it will become subject to the new tax because its underlying rate is less than 19%. The new tax would mean that the whole of the amount distributed would be subject to corporation tax at the non-corporate distribution rate of 19%.

Where a company is caught by the new rate, but the dividend it pays out to non-corporate shareholders is less than the full amount of its profits, the non-distributed element of its profits is taxed at its normal underlying rate.

Apart from the implications of the special tax outlined above, one other possible downside of engineering a situation whereby the bulk of an investor's income is paid as dividends is that it would not help the director concerned to accumulate any substantial pension under an occupational pension scheme, contributions into such schemes having to come from earned income from that "employment". Accordingly, occupational schemes are not a sensible option for companies which intend to pay the bulk of their director/employees' income in the form of dividends. The individuals who receive their income in this way are recommended to invest in a personal pension or a stakeholder pension.

For those companies that do not wish to frame their payment policies around the possibilities for minimising PAYE and NIC liabilities, contributing to occupational pension schemes (and also personal pension schemes) can be extremely tax-efficient in their own right. Provided that a scheme is approved by the Inland Revenue, contributions into it from the sponsoring company are tax-deductible. Exemption from tax on capital gains also allows the fund the opportunity to grow at a healthy rate. Of course, pension schemes are widely seen to have a wider benefit to businesses in that they help in the recruitment and retention of staff.

'HUSBAND AND WIFE' COMPANIES

It is very common in the small company sector for companies to comprise two spouses. Either both partners will be directors or, more commonly, one will be the sole director, and the 'driving force' of the business, while the other will act as the company secretary and play a less active role in the business.

It is long-standing practice among such firms to try to minimise the tax liability of their owners by taking advantage of the various options which exist within tax legislation. One of the most popular arrangements among family companies has been to pay a comparatively modest wage to the

director and/or secretary but then to pay a more substantial sum to one or both in the form of dividends, i.e. shares of the company's profits. The object, in paying dividends rather than wages, is to minimise liability to PAYE and NICs on the part of both the company and the recipient.

This practice has come in for concerted attack from the Inland Revenue as part of a crackdown on 'tax avoidance'. (Tax avoidance, incidentally, has always hitherto been regarded as being a quite legitimate tax planning tool and clearly distinct from tax evasion, which is the criminal refusal to pay a due tax liability). In a case decided by the Inland Revenue's Special Commissioners in 2004,

the Revenue has used the long-standing legislation on settlements to dispute the tax-payers' right to use the option of receiving dividends as opposed to wages.

The object of the settlements legislation is to prevent an individual from gaining a tax advantage by diverting his own income to another person who is liable to tax at a lower rate or not at all. The Revenue's position, as presented to the Special Commissioners, is that any arrangement which leads to a shareholder receiving a dividend which is out of proportion to the value which they create for the company should be regarded as a means of avoiding tax on the income of the principal partner,

who should be liable for tax on the amount distributed.

In the recent case, *Jones v Garratt*, both husband and wife owned shares in their IT company. The husband was the driving business force of the company and was the sole director. The wife was the company secretary. The company paid dividends to both, but the Revenue disputed the dividend paid to the wife. Even though the wife owned shares in her own right and made a substantial contribution to the administration of the business, the Commissioners – by the chair’s casting vote – held that her involvement was duly compensated for by her wages and that the dividend was not commensurate with her role in the business.

This decision was due to be contested in the courts at some point in 2005, partly because of its implications for the separate taxation of husband and wife but also because of the narrowness of the Commissioners’ decision. Tax planning for husband and wife companies will remain in a state of uncertainty until this issue is resolved. In the meantime, businesses of this type should consider, with their accountants, the most appropriate means of arranging their affairs so as not to fall foul of the Revenue’s current policy on settlements.

PREPARING TO INCORPORATE AN EXISTING BUSINESS

For tax purposes, the transfer of an existing unincorporated business to

a corporate body is treated as a cessation of trade for income tax purposes. However the transfer is arranged, there will be a charge to capital gains tax, although this can be offset with expert professional help.

There are two main ways of handling the tax implications of conversion. The first is by using s162 of the Taxation of Chargeable Gains Act 1992. By this route, the tax charge on incorporation can be deferred, in whole or in part, on three conditions: the whole of the assets of the business must be transferred to the company, the business must be transferred as a going concern, and the business must be transferred wholly or partly in exchange for shares issued by

the company to the person who is converting the business.

The second, more complicated alternative is via s165 of the same Act. By this method, the new company is registered before the business is actually transferred to it, and a nominal number of shares are issued for cash to the owner of the business. Then the owner and the company enter into a contract, whereby the goodwill of the business is sold to the company for a nominal amount and all other trading assets are sold at book value. The transferring owner and the company then make a joint election to hold over the chargeable gain arising from the market value of the assets transferred. Stamp duty can be saved by opting not to

transfer the debts of the business, these instead being collected by the owner.

OTHER TAX IMPLICATIONS

This booklet can only give an introduction to the full range of tax implications of incorporation. There are other taxes and tax reliefs which will apply to companies after incorporation. For example, a company will be liable to stamp duty on transfer of assets on formation, on the issue and transfer of shares and on the purchase and transfer of freehold property. It will be subject to capital gains tax on the disposal of its chargeable assets. There are also capital allowances to be taken into account and inheritance tax rules. Given the scale and complexity of these rules

you should seek advice from your accountant on exactly how they might apply to your particular situation.

A simple analysis of the respective tax liabilities of a hypothetical company and a hypothetical unincorporated business which are earning profits of the same level may well suggest that it would be in the interests of a business to incorporate. The process is cheap, private companies need have no minimum capital and there is no longer even a requirement for very small companies to be audited.

The acquisition of corporate status is not, however, a totally pain-free option. Once you assume control of a limited company, you have responsibilities that you never had as a sole trader or a partner. These responsibilities should not be treated lightly: breaches of directors' duties are increasingly

being targeted by the law, and can lead to the disqualification of errant directors and their being made personally liability for their company's debts.

Based on the points discussed in this booklet, the following is a summary of the questions which individuals who are considering incorporating their businesses should ask themselves:

- Do you want the affairs of your business to remain private or are you prepared to file information on them at Companies House?
- Is the risk inherent in your line of business sufficient to make you

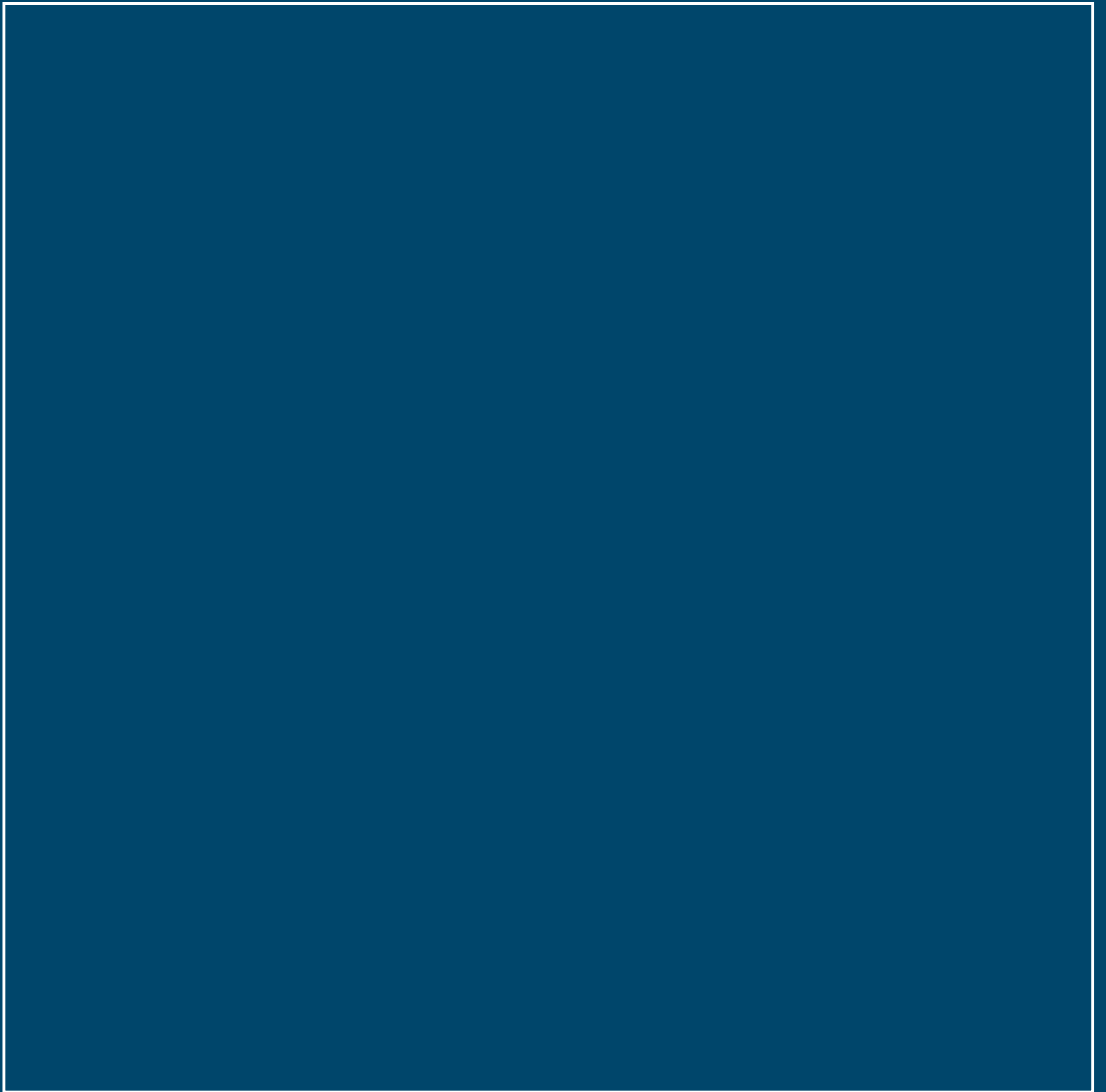
concerned about your personal liability?

- Are you likely to want to raise funds for your business through borrowing or the introduction of new equity partners?
- Are you prepared to assume the responsibilities of acting as a company director?
- Do you think that becoming a company would enhance the status of your business?
- Do you want to be restricted in the way that you can make personal use of the funds of your business?

SUMMARY

- Would you prefer to take a regular, substantial income from your business or are you prepared to rely on your company being sufficiently profitable for you to take the bulk of your income in the form of dividends?
- Is the opportunity to minimise your National Insurance contributions attractive to you?
- Is it important to you personally, and to your employees or prospective employees, that you set up an occupational pension scheme?

Once you have addressed the above points and decided where you stand on them, your accountant will be happy to talk matters through with you and to help you in making a final decision.



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