Application and Professional Skills

Chartered Institute of Taxation
Excellence in Taxation

Taxation of Owner-Managed Businesses

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Taxation of Owner-Managed Businesses

To : Peter Walnut
From : A Tax Advisor
Date : 6th November 2019
Subject : Tax implications of new property maintenance business

Further to your letter dated 29 October 2019, this report sets out the tax implications of your questions raised as well as advising on a proposed structure.

Abbreviations and terms used throughout the report

CGT = Capital gains tax
IHT = Inheritance tax
BPR = Business Property Relief.
NIC = National Insurance Contributions
PAYE = Pay as you earn

Contents

1. Executive Summary

- Initial engagement agreements and anti money laundering checks must be completed before we can provide services to your friend, Phil Peanut
- It is advised to run the business through a company. This will give you limited liability on the business whilst allowing you control over when you can extract profits. It also works well for bringing in family members to work and own shares in the business.
- HMRC must receive notification of the company commencing trade by 31st March.
- Rent and services provided by Walnut Electrics Ltd should be charged ~~at~~ on an arm's length basis.
- The ~~purchase~~ cost of the vans should attract full tax relief in the opening period through capital allowances
- Phil may wish to consider liquidating his current business, using the proceeds to fund the new business, avoiding VAT on transfer of assets

- The business should register for VAT ~~immediately~~ as soon as commencing trading. Clients should be able to recover VAT themselves whilst this will bring you immediate savings.
- General workers, under the proposed ~~emplo~~ contracts, would be deemed employees meaning the business must ~~pay~~ operate PAYE, deducting income tax and NIC. The business itself would be subject to Class 1 secondary and Class 1A NIC.
- Alternatively, the contracts could be tweaked to ensure the workers are treated as self employed for tax purposes, reducing the administrative burden of PAYE and cost of ~~NIC~~ employer's NIC.
- The specialist workers will be treated as self employed and therefore no ~~R~~ income tax or NIC is required to be deducted from their pay. Some ~~may~~ workers may charge VAT ~~to~~ however, providing the business registers for VAT this will be recoverable. ~~to the extent~~

2. New Client onboarding

We appreciate using our services for this advice however, ~~before~~ in order to provide services for your friend ~~Peter~~ Phil we must complete our anti money laundering checks and also confirm an engagement agreement with him personally.

~~We have provided se~~

3. New Business Structure

3.1 Set up as a company

In a similar way as you run Walnut Electrics Ltd, you could choose to run the business through a limited company. ~~Your~~ You will be aware of the benefits of doing so such as:

- limited liability - you will not be personally liable for the business and the extent of your liability will be the amount paid for your shares.
- profits ~~can be~~ are typically charged at a lower rate of tax, 19% corporation tax, rather than income tax at up to 45%, with profits being retained in the company until you choose to extract them. In contrast partnership or sole trade profits are ~~taxed~~ ed on an arising basis.

You may wish to ~~incorporate for~~ split the business 50:50 and ~~th~~ this can be done through the share ownership. We can discuss further how you wish the ownership structure to work at our next meeting.

You had mentioned involving family in the business and running the business as a company will allow you to do this. ~~Shares can be passed to your wife to make use of~~ Once the company has been set up shares can be passed to your wife with no CGT or IHT consequences. Your wife could then receive dividends from the company. ~~Ba~~ Assuming current levels of income will continue she could receive a further £32,850 ~~at 7.5%~~ (appendix 1) at the basic rate of 7.5%.

Your ~~children~~ ~~eld~~ son, working in a similar industry could ~~also~~ be given a contract of employment in the new company as well as being gifted some shares. This will allow some of the profits to be passed to him through salary although HMRC will likely only allow a deduction ~~for~~ in the companies corporation tax return equivalent to ~~the~~ the going market rate for someone of his skills and experience. A salary similar to he is paid now should be accepted.

Passing shares to either your son or your daughter may have IHT and CGT consequences.

~~Poss~~ Transferring shares to your children would create a potentially exempt transfer. The fall in value of your shareholding would be deemed potentially taxable at up to 40 IHT should you ~~not~~ ~~sur~~ pass away within 7 years. However, providing you had held the share for 2 years prior to transfer and your children hold on to the shares for 7 years following the transfer no IHT will arise as BPR will effectively exempt the transfer. ~~Should you decide to set up as a company I would advise you to hold shares in the new company for at least 2 years before transferring to your children.~~

For CGT, as you and your children are connected for tax purposes any gift of shares would transfer at market value creating a disposal for you for CGT purposes. ~~Assuming the thi~~

Assuming the ownership structure of the initial business is 50:50 ~~the bu~~ between you and Phil your base cost for the shares will be half of the initial set up costs i.e. £10,000. ~~The lp~~ Any gain on transfer of shares to your children would be equivalent to the market value of the shares at the point of transfer less the base cost of the shares being transferred (likely to be a proportion of the £10,000). ~~If the~~ This would be subject to CGT, less any annual exempt amount which is currently £11,700, at 10% or 20% depending on your level of income at the time.

Gift relief.

Any gain can effectively be passed to your ~~son~~ children until such a time as they disposes of the shares. This is done through gift relief. Both ~~parties~~ you and your children would need to claim this and effectively means your base cost would transfer over to the children with no gain arising for you. You will need to consider whether you wish for your children to suffer the CGT however, they may also be able to reduce this, through entrepreneurs relief, on the final disposal.

Entrepreneur's relief

Providing you have held the shares for at least 1 year and maintain a holding greater than 5% of the shares you can claim entrepreneur's relief when you either come to dispose of your shares to a third party or transfer the shares to your children. The relief means any gains are taxable at 10%, up to a lifetime gains limit of £10 million.

Although by waiting 2 years from the company beginning to trade any capital gain is likely to increase, you will be able to shelter these by gift relief, the annual exempt amount or entrepreneur's relief. This still provides a benefit by meaning BPR should apply restricting any IHT liability, should the worst happen. ~~I would therefore advise waiting~~ Should you choose to set up as a company I would advise waiting 2 years before transferring shares to children, applying gift relief to defer any capital gain.

When setting up a company, the company itself will be subject to corporation tax. You must notify HMRC of the company beginning to trade within 3 months of company starting to trade. Assuming you do start to trade you must notify HMRC by 31 March 2020.

3.2 Run as a partnership

Alternatively you could run the business as a partnership between you and Phil. You would confirm a partnership agreement, stating how profits should ~~to~~ be allocated. I will assume this on a 50:50 basis until we can confirm at our next meeting. You would need to inform HMRC of the beginning of trade by 5th October ~~The key~~ ~~date~~ You would then be subject to income tax on ~~all~~ your share of profits earned by the partnership. This could be at 20%, 40% or 45% depending on your level of income. You would also be subject to class 2 NIC at £2.95 per week and class 4 NIC at 9% or 2% depending on your level of income.

~~If the~~ You would need to consider ~~a~~ suitable year end as it could have a significant impact on your income tax position. Opening year rules will apply to the first year that, depending on your choice of year end, profits being taxed twice. I would recommend a year end of 31 March, preparing a short accounting period to 31 March 2020 to avoid the double taxing of profits. ~~Profits earned in this period would~~ Relief is only then given when you either leave the partnership or it ceases to trade. ~~Such a short~~ You would then pay income tax and class 4 NIC on these profits by 31 January 2021. ~~In future~~ Income thereon you would pay ~~bal~~ a payment on account equal to half unpaid income tax and class 4 NIC in the previous year on 31 July 31 ~~July~~ January following the end of the tax year with balancing payments required on 31 January.

One advantage of running as partnership is being able to make use of any losses ~~ea~~ to reduce your income tax liability. In contrast, a company's losses remain in the company. ~~Opening Losses made in a partnership can be used to reduce taxable income in~~ Should the partnership have taxable losses in the first 4 years of trade you could use these to reduce taxable income in the previous 3 years.

This can be very useful ~~especially it the~~ as businesses often make taxable losses when beginning to trade.

~~You could~~ Losses made at any point could also be used against income in that same year or prior year. This is clearly an attractive ~~op~~ feature of trading as a partnership.

~~The~~ Should you make family members partners ~~they would be restr~~ but not involved in managing the partnership they would be restricted in their use of losses to the greater of their adjusted net income or £25,000.

~~One~~ One major drawback of running the business through a partnership is you would lose the limited liability you would have ~~throus~~ by running this through a company. You could then be personally liable for ~~any~~ the business.

It is possible to operate as a limited liability partnership, giving you and Phil limited liability for the business. Your liabilities would be capped at your capital contribution which would be £10,000 each. However, should you decide to operate as an LLP you would be restricted on the losses you could use, to your capital contribution of £10,000. This would ~~to reduce~~ significantly impact the main tax benefits of operating as a partnership.

Should you decide to offer your ~~children~~ wife a partnership share there would again be no CGT or IHT consequences. Passing to your children would result in a capital gain on the individual assets in the partnership itself. You would effectively be giving them a share of any assets in the partnership. ~~a~~ ~~BPR~~, Gift relief ~~would cont~~ and entrepreneur's relief would continue to apply as in the same way for company shares. BPR would also be available and again, it would be advisable to wait 2 years before transferring any partnership share to them.

For the reasons described, it ~~would make most~~
I would advise setting up a company. This provides limited liability, and allows to determine when profits are extracted from the company. This can bring tax savings.

3.3 Other considerations

~~3 Use of 3.3.1 Use of building owned by Walnut~~

3.3.1 Services provided by Walnut Electrics Ltd

~~4~~ Rent ~~and fees to~~ for the use of the building and fees for the services provided by Walnut Electrics Ltd should be made at an arm's length value. ~~HMRC will likely see thi~~ The companies will be connected for tax purposes and HMRC may challenge any amounts used.

3.3.2 Vans

~~Van~~ The purchase of vans should attract a full deduction in the opening period through capital allowances. These should quality for the annual investment allowance which will still be available if electing for shorter periods. ~~Rona~~ A company would get a full deduction for this but the partnership would restrict private use, another benefit for operating as a company

3.3.3 Phil's transfer of business

We can provide detailed advice for Phil ~~on~~ on completion of the engagement process however, ~~I would sug~~ if he wishes to transfer the assets to the business they will be subject to VAT. Therefore, if he wishes to cease trading he ~~would~~ may wish to liquidate the assets and use the proceeds to fund his investment in the new business.

This is because the transfer would not be a transfer of a going concern as he is not currently VAT registered ~~and~~ and this will be a different business that will be carried out.

No CGT should arise as the only capital gains asset is the van however, as ~~cost~~ cost and assumed market value are less than £6,000 no ~~gain~~ capital gain will arise. ~~A third~~ On cessation of trade he may have an adjustment to trading profit being the realisation of stock at market value and disposal of ~~cap~~ machinery.

~~VAT~~ 3.3.4 VAT

Assuming you will be generating taxable supplies ~~of~~ at least £85,000 you must register for VAT and charge VAT, as applicable, on your services. Given your clients will also be businesses they will likely be able to recover this. You ~~should consider~~ will be required to register for VAT when:

- the business has made taxable supplies for £85,000 in the past 12 months, calculated monthly or;
- the business ~~AA~~ is expected to make taxable supplies of £85,000 in the coming month.

You may not be required to register for VAT immediately however, I would advise you to do so to recover any input VAT suffered by the business. Your customers will be able to recover this where they are VAT registered which ~~appears to~~ should be the case.

4 Tax treatment of workers

Whether someone is employed or self employed for tax purposes is ~~decided~~ based on case law and is ~~based~~ determined on balance of the facts. These are considered for the general and specialist workers.

General workers

Paying someone an hourly or daily rate is a sign of an employer employee relationship. This appears to be the case here. Other factors which look to suggest ~~this~~ they will be treated as employees are:

- The business ~~expects~~ is choosing when they work as noted in (4) on exhibit C. Typically self employed workers have more control as to when they work providing they complete the service being given as agreed.

- providing workers with tools is a clear sign of these being employees. Being reimbursed for providing their own tools shows they are not expected to do so.
- the employees are to be provided with company vehicles which is a clear sign of employment.

At the same time, no sick pay, holiday pay or other benefits are paid which points to self employment. Finally, payment being made only on satisfactory completion of the work would be a strong indicator of self employment on its own.

On balance however, HMRC will ~~co~~-weigh all of these factors up to determine whether they are employed or self employed. It is likely that on balance they will be deemed to be employees.

[redacted]

Taxation of Owner-Managed Businesses

The impact of this for the business is that it will have to deduct income tax and NIC through PAYE. This will be a significant administrative burden particularly if you haven't done this before. You must make a full payment submission each month and pay all relevant income tax and NIC by 19th of the following month or 22nd if made electronically.

You will also be subject to class 1 secondary contributions at 13.8% of the employees salary. This can be a significant cost although this will be deductible for tax purposes for both Corporation tax and as a trading expense for a partnership.

~~You may wish~~ ~~to~~ If you wish to avoid these costs and administrative burden I would advise changing the contracts to ~~cover~~ be more along the lines of being self employed. This could be done by offering a price for a service rather than hourly rate and not providing equipment ~~etc~~ or uniforms.

This would mean you would only pay the fee for the service rather than the employment taxes and operating a PAYE system. ~~Howev~~

~~Assuming profits of you will be generating taxable supplies of at least £85,000 you must register for VAT and~~

Specialist workers

All factors look to suggest these are contracts for service rather than contract of employment. No tools will be provided, ~~&~~ they will be able to choose when they work ~~is~~ and they must provide a suitable guarantee for the work meaning they are ~~perso~~ liable for the service. Therefore ~~they a~~ these workers will not be employees and only the fee will need to be charged, no income tax or NIC will be charged. However, ~~where they the business is charging busines~~ some of the businesses ~~they will~~ being used may be VAT registered themselves meaning VAT may be chargeable. However, as long as ~~Bea~~ your new business is VAT registered you can recover this, to the extent it ~~is~~ you are making taxable supplies

Appendix 1 - Wendy Walnuts taxable income

Salary	8,000
Dividends	7,500
Less: dividend allowance	(2,000)
Net income	13,500
Less: Personal allowance	(11,850)
taxable income	1,650
Remaining basic rate band	32,850

RAN

1 – mention new AML/EL etc on Phil

Newco – incorporation
- CT etc
- he will know about this
- BPR/CGT – pass to children
- Limited liability
- shares to children? wife? Utilise div exemption.

ER
GR
3 months' notice

Partnership – as if ST
- IT — opening year rules.
- C2/4 NIC
- POA etc
- o/lap profits — POA
- if LLP (restrict losses to cap contr = 20k)
- if opening losses (common for new business) can make better use than if in co.
- individual assets transfer (CGT)
  partnership interests (IHT — BPR)

family couldn't use losses unless running own

~~Set up ER pers company~~
- services provided by oldco – fair rates / IR35? ← connected companies

Both – charge newco/le rent on use of existing property? FV
- deduction ~~oldco~~ newco / ~~property~~ income for oldco.

Res + commercial – VAT?

Phil – if he transfers assets either to co or partnership
- no CGT (van – chattels), plant, stock
- ~~plant~~ may have trading profit on transfer to business
- ~~may~~ will need to charge VAT – not a TOGC.

Consider service or employment.

Vans – capital allowances.

Cease to trade + transfer cash. rather than buying in assets.

Register for VAT – customers should be reg + can recover

20
5
40
10
25

General workers ee + implications.
Specialist s.e.

PAYE

30

[redacted]

30/6
Peter
Ltd. co
Electrician

30/6
Phil – wife earns £15k in chemist.
ST
Builder

Property maintenance business

~~IR35 / cons Peter ? Phil~~ Handy service

small dimension. VAT?

To be passed on to children
(Peter – 2, Phil – 1)
How will this work in practice?
(i) Set up new co.
(ii) set up partnership (consider LLP) < use of losses c/f
implications of using current assets
~~(iii) Carry on business through co. or ST scheme?~~

Nutville properties
– 24 call outs
– ad hoc
• retainer + variable

res
commercial
~~EVA~~

Similar agreements with other property owning businesses

Current co. premises used for storage + admin.

Capital allowances – Vans

each month. – 19/22
P11D – 6th July
6th October

General workers – ee vs s/e
– PAYE implications – IT/NIC

Specialists – ~~See~~ ee vs s/e
– no IT/NIC
– VAT?

Current business:
• If provide services for new business IR35?
• Ensure fair rates charged.
Rental income on the property for co. + deduction for newco?

new client
– AML
– engagement letter.

IT/CT/NIC/VAT/IHT/CGT/SD