Institution **CIOT - ATT-CTA**
Course **CTA APS Owner-Managed Businesses**

Answer-to-Question-_1_

REPORT

TO: Teresa Ryan and Rohat Saj

FROM: SPD Accountants LLP

DATE: November 2022

SUBJECT: Business structures for protection against personal risk exposure and associated tax implications

INTRODUCTION

This report is provided to you (Teresa and Rohat) in response to the issues raised in your email of 24 October 2022.

This report is intended for use by you only. Liability is not accepted to others who may rely on the report.

Our report comprises three sections as follows:

A. Alternative business structures
B. Incorporation
C. Proposed sale of business premises

Once you have had the chance to read through the report, we would be happy to meet with you to discuss this further together with any queries you may have.

This report uses the following abbreviations:

Income Tax = IT

Corporation Tax = CT

Capital Gains Tax = CGT

Business Asset Disposal Relief = BADR

Inheritance Tax = IHT

Value Added Tax = VAT

National Insurance Contributions = NICs

Personal Allowance = PA

Market Value = MV

EXECUTIVE SUMMARY

The main points from our report can be summarised as follows:

- You could consider either a Limited Liability Partnership ("LLP") or a limited company to limit your personal risk exposure.

- Moving to an LLP should not give rise to any tax implications however LLPs are taxed in the same way as general partnerships, so as profits increase so would your income tax exposure.

- We would recommend moving to a limited company as although this brings added complexity it allows for flexibility on the extraction of funds and the potential to reduce your tax exposure going forwards. Based on taxable profits of £300,000 there could be annual savings of £4,577 compared to remaining as a partnership.

- On incorporation there is a cessation of trade for income tax purposes, and a commencement for corporation tax purposes. We would recommend making elections to transfer assets qualifying for capital allowances at £1, and work in progress at cost, to the company to avoid additional trading profits in the final period.

- The incorporation would give rise to capital gains on the premises and goodwill totalling £1m (Teresa £600k and Rohat £400k). The gains could be deferred by way of incorporation relief or gift relief.

- We would recommend that partial incorporation relief is claimed with the consideration split in the form of say 50% shares and 50% loan stock. This would give rise to a small CGT liability of £2,770 for Teresa and a CGT liability of nil for Rohat.

- The consideration in the form of loan stock (c£675k) could then be drawn down tax-free. This would reduce the level of dividends that you would need to extract giving rise to further income tax savings.

- We would recommend discussing with your bank as to whether they would permit the transfer of the long term loan to the company, particularly in light of the recent refinancing.

- Where incorporation relief applies, the CGT base cost of the premises for the company would be the market value on acquisition of £400,000. On a future sale of the premises by the company, any growth in value would give rise to a capital gain subject to CT at 19%.

- If a new premises were acquired by the company in the period 12 months before and 36 months after the disposal, rollover relief could apply to potentially reduce the gain to nil. We can consider this further closer to the time.

SECTION A. Alternative business structures

Currently you are running your business, Pinnacle Architects, as a general partnership. As you are aware, whilst operating in this structure yourselves as partners have joint and several unlimited liability for the obligations business. This means that if the business were to fail you would be personally liable.

One very simple solution would be to increase the level of your professional indemnity insurance cover. However, we have assumed that this is not practical and you would like to consider other options.

There are two main alternatives that you could consider, either a Limited Liability Partnership ("LLP") or a limited company. We have considered both below.

LLP

An LLP limits your liability as partners to the amount of your capital contribution, so your personal risk exposure is significantly reduced.

For tax purposes, an LLP operates in exactly the same way as a general partnership. You would each still be subject to income tax on all profits of the LLP as they arise, and class 2 and class 4 NICs would be payable in the same way as currently.

However, as you have identified this means that as profits increase you would suffer higher marginal rates of tax. As you are aware, where your income exceeds £125,140 your personal allowance is tapered to nil, and for income in excess of £150,000 this is subject to income tax at 45%, in addition to class 2 and class 4 NICs.

As shown at Appendix 1, based on taxable profits of £300,000 Teresa would have a total IT and NICs liability of £71,484 and Rohat £45,827.

Moving to an LLP from a general partnership should not give rise to any tax implications so would be a simple way to limit your risk exposure with minimal change to how you currently operate. However, your tax exposure would be quite significant especially as profits are projected to increase.

Company

With a limited company, this provides the protection of liability limited to the share capital contributed, so again would significantly limit your personal exposure.

With a company, taxable profits earned by the company are first subject to corporation tax ("CT") at a rate of 19%. Funds must then be extracted by yourselves as employees/shareholders, however there is flexibility over how this can be done and there is no requirement to extract all post-tax profits.

- Extraction of funds

Funds can be extracted in the following ways:

- Salary - salary is subject to income tax at 20/40/45%, plus class 1 NICs. Class 1 primary NICs are payable by the employee as 12/2%, and class 1 secondary NICs payable by the company at 13.8%. The salary payments and class 1 secondary NICs are a deductible expense for CT purposes. This makes salary quite expensive particularly due to the NIC cost.

- Dividends - dividends are subject to income tax at the lower rates of 7.5/32.5/38.1%, in addition to the dividend nil rate band of £2,000 taxable at 0%. No NICs are payable on dividends, however they are not a deductible expense for CT purposes. This is generally a tax-efficient way to extract profits.

- Pension - employer pension contributions are a tax-free benefit, and a deductible expense for CT purposes. However, as you are each close to your lifetime allowance limits this is not recommended due to the high tax charges on extraction where the lifetime allowance is exceeded.

- Rent - rent can be charged to the company where a building is held personally. Rent is subject to income tax at 20/40/45%. No NICs are payable and it is a deductible expense for CT purposes. If possible, this can be a tax-efficient option.

- Interest - interest can be charged where loans are made to the company. Interest is subject to income tax at 20/40/45%, however each individual has a personal savings allowance. For higher rate taxpayers as you are currently, this is £500 which can be received tax free. However if you become additional rate taxpayers, there is no personal savings allowance. No NICs are payable on interest and it is a deductible expense for CT purposes. If possible, this can be a tax-efficient option.

- Loan account - where loans are made to the company, repayments of those loans can be taken tax-free.

A typical remuneration strategy would be to take a small salary equal to the secondary threshold for NIC purposes, with the balance of income required by way of dividends. A salary equal to the secondary threshold means that no NICs are payable by either you or the company, but preserves your entitlement to benefits such as the state pension.

At Appendix 1 we have shown an illustrative position based on taxable profits of £300,000, with salaries of £8,840 to each of you and the balance of available profits extracted as dividends. This gives rise to a CT liability of £53,641, plus IT liabilities of £38,996 for Teresa and £20,097 for Rohat.

Overall, this means that after tax the net retained profits are £187,266 with a company, compared to £182,689 remaining as a partnership - a saving of £4,577 per year (see Appendix 1).

These savings would increase if not all profits were extracted from the company, and also as profits increase further.

Recommendation

Overall we would recommend moving to a limited company structure, as this mitigates your personal risk exposure and has the potential to reduce your overall tax liabilities going forwards.

There is some complexity with moving to a limited company which is covered in the next section.

SECTION B. Incorporation

Moving to a limited company is a process known as "incorporation". This results in the cessation of trade for IT purposes, and a commencement of trade for CT purposes.

We would suggest that the new company should commence trading on 1 April 2023, after the end of the current accounting period. Accounts could then be drawn up to any date, but we would suggest

31 March annually thereafter, in the same way as the current partnership.

The company should notify HMRC of it's commencement to trade within 3 months, so by 30 June 2023.

We have assumed for the purposes of this report that your shareholdings in the company would be Teresa 60% and Rohat 40% as per the current partnership, although you could agree an alternative split if preferred.

Income Tax ("IT")

The cessation of trade would occur on 31 March 2023. For the 22/23 tax year, you would be taxed on the partnership profits of the year ended 31 March 2023 in the usual way.
Following incorporation you would no longer be liable to pay class 2 and class 4 NICs.

- Capital allowances

In the final period before cessation, no allowances can be claimed. Any assets held are deemed to be sold at market value, giving rise to balancing adjustments.

The valuation report suggests that the valuation of other net assets is £50,000, compared to a balance sheet value of £48,520 (see Appendix 2).

We shall therefore assume for the purposes of this report that the net book values of assets qualifying for capital allowances, being the equipment and vehicles, is equal to their market value.

Assuming the tax written down value ("TWDV") remains as nil as at 31 March 2023, this would give rise to a balancing charge of £169,200 (equipment £129,000 plus vehicles £40,200). The company would then acquire the assets for their market value of £169,200, and claim capital allowances over time giving CT relief at 19%.

This would be added to taxable profits in the final accounting period.

Alternatively, an election can be made to transfer the assets to the company at TWDV. Where this is nil, then no balancing charge arises. The company would acquire the assets at nil and no capital allowances could be claimed going forwards.

Alternatively, an election could be made to transfer the assets to the company for another value, say £1. This would be appropriate if the TWDV is a positive figure at 31 March 2023. The company would then acquire the assets for £1 giving negligible CT relief.

We would recommend to make an election to transfer the equipment and vehicles to the company for £1. This avoids the balancing charge of £169,200 so saves IT in the final period at 40/45%, compared to a CT saving at 19% over a period of time.

- Work in progress ("WIP")

For work in progress, this is deemed to be sold at market value on cessation. Where this is excess of the balance sheet value as at 31 March 2023, additional trading profit will arise.

Alternatively, you could elect to transfer the WIP to the company at the higher of cost or price paid. This would avoid the additional trading profit in the final period taxed at 40/45%, and instead give rise to a profit in the company when sold which would be taxed at 19%.

Assuming the value of WIP at 31 March 2023 is in excess of balance sheet value, we would recommend making the election to transfer at cost, which would mean the profit on sale is taxed at CT rates of 19% instead of IT rates at up to 45%.

Capital Gains Tax ("CGT")

On incorporation, chargeable assets are deemed to be sold to the company for their market value.

The chargeable assets within the partnership are the freehold premises and equipment.

Based on the valuations provided (which we assume will stil be accurate as at 31 March 2023), the goodwill has a MV of £900,000 and the premises a MV of £400,000.

For CGT purposes, in the current partnership you each own a fractional share in the assets held by the partnership. For Teresa, your CGT base cost is therefore 60% of the cost to the partnership, and for Rohat the remaining 40%.

This means that on incorporation, capital gains totalling £600,000 for Teresa and £400,000 for Rohat (see Appendix 2) would arise.

Assuming you make no other disposals in 22/23 and your capital losses are still available, these can be offset in calculating the taxable gains.

As you are higher rate taxpayers CGT is charged at a rate of 20%, or 10% to the extent that BADR applies.

BADR applies to a disposal of whole or part of an interest in a partnership which has been owned for at least 2 years. However, it does not apply to goodwill on incorporation. Qualifying gains are taxed at 10% up to a Lifetime Limit of £1m per individual.

You would each be disposing of the whole of your partnership interest which has been owned for more than 2 years, so BADR should apply however only to the gain in respect of the premises and not the goodwill.

As a result, your AEA and capital losses should be allocated to the gain on the goodwill to save CGT at the highest rate.

Overall, this gives a CGT liability of £52,340 for Teresa and £29,740 for Rohat (see Appendix 2).

However, there are certain reliefs that can be available as discussed below.

- Incorporation Relief

Incorporation relief applies automatically where all of the assets of a business (except cash) are transferred to a company for consideration wholly or partly in the form of shares.

The gain is not charged but instead deducted from the base cost of the shares acquired. This means there is a higher gain when the shares are later sold.

The company inherits the assets at MV which would become it's CGT base cost in the event of a future sale. In particular for the property, the company would acquire it for MV of £400,000.

If full incorporation relief were claimed, this would waste the substantial capital losses that you each have carried forward.

However, it would be possible to claim partial incorporation relief. This could be done by way of some of the consideration being in the form of shares, and some in the form of loan stock. Only the gain in respect of the share consideration can be deferred, and the remaining gain in respect of the loan stock would remain chargeable. This would then be offset by the AEA and brought forward capital losses.

- Gift Relief

Alternatively, assets could instead be gifted to the company. Gift relief can be claimed for business assets which would apply to both the premises and the goodwill.

With gift relief, the gain is not charged but instead deducted from the base cost of the assets in the hands of the company.

In particular for the premises, this means that the company would acquire the premises for their MV of £400,000, less the gain of £220,000, giving a CGT base cost of £180,000. This means there would be a higher CGT liability when the property is later sold, plus further tax if the proceeds are extracted.

Gift relief gives added flexibility as not all assets must be transferred to the company. Instead, the premises could be retained personally and only the goodwill gifted to the company.

Retaining the premises personally would allow for rental income to be extracted until the property is sold, which can be tax-efficient (see Section A). However, this would only be for 3-5 years so may not be significant.

On a sale of the property any gain would be subject to CGT based on the growth in value. However, BADR is unlikely to be available if this takes place 3 years after the incorporation of the business, so CGT would be at a rate of 20% from the original cost of £180,000.

- No Relief

The final option is not to claim any tax reliefs, sell the assets to the company and suffer the CGT liability. This is reduced by your substantial capital losses, although there is still a substantial liability of c£82k between you.

For the other net assets of £50,000, these could be sold to the company and consideration left outstanding in the form of a loan account. Repayments could then be extracted tax-free, although given the amount this would not be significant.

Recommendation

Overall we would recommend that assets are transferred to the company by way of incorporation relief, with mixed consideration. We would suggest that the consideration is split 50% shares and 50% loan stock, meaning that 50% of the gains would qualify for incorporation relief and the remaining 50% would remain chargeable.

As shown at Appendix 2, this would leave Rohat with a CGT liability of nil and capital losses of £7,300 carried forward, and Teresa with a small CGT liability of £2,770 and no capital losses carried forward.

The CGT liability would be payable on 31 January 2024 and BADR should be claimed by 31 January 2025.

An alternative consideration split could be agreed to either fully utilise Rohat's capital losses or bring Teresa's CGT liability to nil.

This approach means that the company acquires the premises for market value of £400,000, reducing the gain on a future disposal (see Section C).

The consideration left in the form of loan stock would then be a total of £675,000 (being 50% of the total market value £1,350,000), which could be drawn down tax-free. This would reduce the level of dividends that you would need to extract giving rise to further income tax savings.

If you remain higher rate taxpayers up to £500 interest each per year could then be charged to the company tax-free. You could restrict dividends extracted from the company to bring your total income to no more than £150,000 so this remains the case.

Value Added Tax

For VAT purposes, the transfer of business to the company should be treated as a transfer of a going concern ("TOGC") and be outside the scope of VAT.

This is on the basis that the company would carry on the same kind of business, the company becomes VAT registered, there is no significant break in trading and there are no consecutive transfers of the business.

The partnership should deregister from VAT within 30 days of cessation and the company should register for VAT from commencement.

The company could take over the VAT registration number of the existing partnership, although this is not recommended as it would also take on the past VAT history.

For the building, this is an old commercial building on which no option to tax has been made, so it is exempt from VAT. As a result it can be included as part of the TOGC.

Stamp Duties

Ordinarily there would be SDLT on the purchase of the property by the company, however the special partnership provisions mean this can be reduced to nil. This is on the basis that both of you as partners become shareholders in the company, so there is no change in ownership.

There is no stamp duty on the issue of new shares by the company.

Inheritance Tax

There should be no IHT on the transfer to the company as there is no "loss to donor", i.e. the value of your assets if the same before and after.

Both an interest in a partnership and shares in unquoted trading companies qualify for 100% Business Property Relief ("BPR"), so can be exempt from IHT provided the property has been owned for at least 2 years.

On the basis that the architect business is treated as trading for BPR purposes (which is likely) then both the partnership and the new company should qualify for 100% BPR.

Other issues

Other commercial and legal issues must also be considered on the incorporation to a company.

Part of the incorporation would involve the transfer of the existing long term loan (£262,000 as at 31 March 2022) to the company. As you have recently refinanced, the bank may not permit the loan to be transferred. We would recommend discussing this with your bank and if necessary the loan may need to be refinanced again by the company.

For your existing employees, these should transfer to the new company under the TUPE regulations. We would recommend that you seek legal advice in this regard.

We would recommend that on incorporation of the company, you have a shareholders agreement which sets out your respective responsibilities. This would be important in the event that the relationship between you were to subsequently break down in the future.

SECTION C. Proposed sale of business premises

In regards to the proposed sale of the business premises, following the steps above this would now be held by the company and it's CGT base cost would be the market value on acquisition of £400,000.

This would be more beneficial compared to if gift relief were claimed, as the company's CGT base cost would be £180,000, being reduced by the gain of £220,000 rolled over. This would mean that the gain on sale would be increased by £220,000, increasing the CT liability by £41,800 (£220,000 at 19%).

Similarly, if the property were retained personally your CGT base cost would be £180,000, giving rise to a higher gain on disposal. As BADR is unlikely to be available the gain would be taxed at 20%.

On disposal of the property by the company in three to five years' time, any increase in value from £400,000 would give rise to a capital gain. This would be included in total profits and subject to CT at a rate of 19%.

No indexation allowance would be available as this ceased in December 2017 and the company acquired the premises after that date.

However, you would then need to consider the premises that you would use to operate your business following the sale.

One option is to rent alternative premises. The rental payments would be a deductible expense for CT purposes so save CT at 19%.

Alternatively, you could consider purchasing new premises in the company. If the proceeds on disposal of the old premises were fully reinvested, then rollover relief could be available. This would apply if the new premises were purchased by the company in the period 12 months before and 36 months after the sale of the old premises.

If the proceeds are fully reinvested and the new premises are used exclusively for business purposes, then full rollover relief would apply. The gain on sale of the old premises would not be charged but instead deducted from the base cost of the new premises acquired, reducing the CT liability to nil.

Rollover relief can be restricted if not all of the proceeds are reinvested or if the old/new asset is only partially used for business purposes. We can consider this further closer to the time.

APPENDICES

Appendix 1. Comparative tax position based on taxable profits of £300,000

Partnership

Taxable profit allocation:

	Total (£)	Teresa (£)	Rohat (£)
Salaries	19,000	9,500	9,500
PSR 60:40	281,000	168,600	112,400
Total	300,000	178,100	121,900

Income tax position:

Teresa		£	Rohat		£
Trade profits		178,100	Trade profits		121,900
Personal allowance ("PA")	W1	nil	PA	W1	(1,620)
Taxable income		178,100	Taxable income		120,280
BRB 37,700 @ 20%		7,540	BRB 37,700 @ 20%		7,540
HRB 112,300 @ 40%		44,920	HRB 82,580 @ 40%		33,032
ARB 28,100 @ 45%		12,645	ARB nil		-
IT liability		65,105	IT liability		40,572
Class 2 NICs	W2	159	Class 2 NICs	W2	159
Class 4 NICs	W3	6,220	Class 4 NICs	W3	5,096
NIC liability		6,379	NIC liability		5,255
IT and NICs		71,484	IT and NICs		45,827

W1. The standard PA is £12,570, but this is tapered by £1 for every £2 that income exceeds £100,000.
Teresa's income is in excess of £125,140 therefore her PA is tapered to nil.
For Rohat, available PA = 12,570 - (121,900 - 100,000) / 2 = £1,620

W2. Class 2 NICs are payable at £3.05 per week, therefore £3.05 x 52 = £159.

W3. Class 4 NICs as follows:
Teresa = (50,270 - 9,568) @ 9% + (178,100 - 50,270) @ 2% = 6,220
Rohat = (50,270 - 9,568) @ 9% + (121,900 - 50,270) @ 2% = 5,096

Company

		£	
Adjusted profits		300,000	

Salaries	W1	(17,680)	
Taxable profits		282,320	
CT @ 19%		(53,641)	
Net profits		228,679	
Dividends:			
Teresa (60%)		(137,207)	
Rohat (40%)		(91,472)	
Remaining profits		nil	

W1. Assuming salaries equal to Class 1 secondary threshold of £8,840 each, so a total of £8,840 x 2 = £17,680.

Income tax position:

Teresa		£	Rohat		£
Salary		8,840	Salary		8,840
Dividends		137,207	Dividends		91,472
Total income		146,047	Total income		100,312
PA	W2	nil	PA	W2	(12,414)
Taxable income		146,047	Taxable income		87,898
NSI BRB 8,840 @ 20%		1,768	NSI BRB 8,840 @ 20%		1,768
DI DA 2,000 @ 0%		-	DI DA 2,000 @ 0%		-
DI BRB 26,860 @ 7.5%		2,015	DI BRB 26,860 @ 7.5%		2,015
DI HRB 108,347 @ 32.5%		35,213	DI HRB 50,198 @ 32.5%		16,314
IT liability		38,996	IT liability		20,097

W2. Teresa's income is in excess of £125,140 therefore her PA is tapered to nil.
For Rohat, available PA = 12,570 - (100,312 - 100,000) / 2 = £12,414

Summary

Partnership	£	Company	£

Profits	300,000	Profits	300,000
Teresa IT	(65,105)	Teresa IT	(38,996)
Rohat IT	(40,572)	Rohat IT	(20,097)
Teresa NICs	(6,379)	Teresa NICs	-
Rohat NICs	(5,255)	Rohat NICs	-
CT	-	CT	(53,641)
Net position	182,689	Net position	187,266
		Saving	4,577

Appendix 2. Incorporation

Capital Gains

		Teresa (£)	Rohat (£)
Goodwill:			
Proceeds (MV)	W1	540,000	360,000
Cost	W3	(72,000)	(48,000)
Gain		468,000	312,000
Property:			
Proceeds (MV)	W2	240,000	160,000
Cost	W3	(108,000)	(72,000)
Gain		132,000	88,000
Total gains		600,000	400,000

W1. MV of £900,000 split Teresa 60:Rohat 40.
W2. MV of £400,000 split Teresa 60:Rohat 40.
W3. For CGT purposes, the partners have a fractional share in the assets owned by the partnership. Goodwill cost = £120,000 and Premises cost = £180,000, split 60:40 per the capital sharing ratio.

CGT calculation:

Teresa	BADR	Non-BADR	Rohat	BADR	Non-BADR
Gains	132,00	468,000	Gains	88,000	312,000

	0				
AEA		(12,300)	AEA		(12,300)
Capital losses		(260,000)	Capital losses		(195,000)
Taxable gains	132,000	195,700	Taxable gains	88,000	104,700
BADR @ 10%		13,200	BADR @ 10%		8,800
CGT @ 20%		39,140	CGT @ 20%		20,940
CGT liability		52,340	CGT liability		29,740

Incorporation Relief

Suggestion for consideration to be split as 50% shares and 50% loan stock, meaning that incorporation relief would apply for 50% of the gains as shown below.

Teresa	BADR (£)	Non-BADR (£)	Rohat	BADR (£)	Non-BADR (£)
Gains	132,000	468,000	Gains	88,000	312,000
Incorporation relief	(66,000)	(234,000)	Incorporation relief	(44,000)	(156,000)
Gain after relief	66,000	234,000	Gain after relief	44,000	156,000
AEA		(12,300)	AEA		(12,300)
Capital losses	(38,300)	(221,700)	Capital losses	(44,000)	(143,700)
Taxable gains	27,700	nil	Taxable gains	nil	nil
BADR @ 10%	2,770				
CGT liability	2,770		CGT liability	nil	

Teresa capital losses carried forward = 260,000 - 221,700 - 38,300 = £nil
Rohat capital losses carried forward = 195,000 - 143,700 - 44,000 = £7,300

Other assets

		£	
Net assets as at 31.3.22		264,520	
Goodwill		(36,000)	
Premises		(180,000)	
Other net assets as at 31.3.22		48,520	
Value per valuation report		50,000	