The Chartered Institute of Taxation

Application and Professional Skills

Taxation of Owner-Managed Businesses

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Suggested solution

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Report to the partners of Pinnacle Architects on limiting personal liability and possible tax efficient operating structures.

Introduction

The objective of this report is to address the issues raised in your email of 24 October 2022. Specifically, this report considers what actions can be taken to:

a) Reduce the personal business risk exposure for the existing partners.
b) Mitigate the partners' income tax and NIC liabilities whilst maintaining your net income.

This report is for the benefit of T Ryan and R Saj, the partners of Pinnacle Architects. The details and advice given should not be relied upon by any other party.

Executive Summary

Personal business risk is a key concern and this can be addressed in one of two ways: either by conversion of the existing partnership into a limited liability partnership (LLP) or incorporation of the business into a limited company. The operating structure you choose should ideally offer an opportunity to reduce the personal income tax liabilities of the partners.

Both the conversion to an LLP and full incorporation address the business risk concerns. As such it is likely that tax considerations will be a deciding factor.

In general, profits earned in a limited company and fully extracted for your personal use are more likely to attract higher overall levels of total tax than the same profits earned in an LLP. This would tend to indicate that the LLP could be more advantageous, but this fails to take account of a key planning opportunity that arises through the action of incorporation itself. This is principally achieved through the creation of substantial directors' loan accounts on incorporation. The subsequent tax-free draw-down of these loan accounts will allow you to maintain your income levels but also control your marginal tax rates. Once the directors' loans have been fully drawn down then your annual tax liability is likely to increase if you intend to withdraw most or all of the profits arising to the business.

On balance we would recommend that you consider incorporation to a limited company. Whilst there is an initial up front tax cost in the form of Capital Gains Tax , this is outweighed by income tax benefits over the next five to ten years whilst you are able to draw down on your directors' loan accounts. You have indicated that a sale of the business is unlikely within the next ten years. Obviously it is likely that personal circumstances and objectives together with legislation will have changed over this timescale and the operating structure can be reviewed at that stage.

We recommend that the freehold premises should be retained in your personal ownership, rather than being transferred to the new company. In addition to avoiding an immediate Capital Gains Tax liability this will remove the risk of a double layer of taxation if the property were held in a company.

Business risk mitigation

Under your current operating structure, the partners are jointly and severally liable for all business liabilities. In the event of a large uninsured claim then this could result in substantial personal exposure or even bankruptcy. Both the increased size of the business and the changing profile of your clients means that this personal exposure is no longer acceptable. I have set out below two operating structures that, in the absence of fraudulent or wrongful trading could significantly reduce any personal liability exposure.

Limited Liability Partnership (LLP)

A common mechanism to address unlimited personal risk is to transfer the business into an LLP. This operating structure is very similar to your existing partnership. The key distinction is that the LLP is a separate legal entity independent of the individual members (equivalent to partners). The business risk of the members is limited to their capital invested or retained in the LLP and any personal guarantees. As such, in the absence of member's individual negligence then the LLP would offer the business risk protection you require.

Limited Company

A more familiar structure is the limited liability company. Again, this is a separate legal entity. The financial exposure of the shareholders is limited to their capital commitment to the company (typically in the form of share capital and loans) and any personal guarantees.

You will note from the above both the LLP and limited company meet your objective of personal risk mitigation. As such we have considered below your other key objective of tax efficiency.

Tax mitigation

The tax treatment of an LLP is very different to that of a limited company. The two structures are compared in detail below:

Taxation in a LLP

Although the LLP is a distinct legal entity it does not have any direct tax liability. The tax treatment of the profits arising to the LLP is virtually identical to that of your existing partnership. That is the profits are allocated to the members of the LLP and the members are subject to income tax and Class 2 and 4 National Insurance Contributions on those profits. This is regardless of what profits you actually draw from the LLP.

This is illustrated in Appendix 1 using an assumed profit of £300,000.

The conversion of the partnership into an LLP is not a cessation of trade for income tax purposes. Provided there is no change in profit sharing ratios on transfer to the LLP then there is no disposal for Capital Gains Tax purposes.

The transfer of property into the LLP is potentially subject to SDLT but there is a specific exemption provided the transfer takes place within 12 months of the creation of the LLP and there is no change in the make-up of the partnership.

For VAT purposes this should be a transfer of a going concern and therefore outside the scope of VAT.

Taxation in a limited company

The tax treatment of a limited company is completely different. Profits arising to the company are subject to corporation tax. Until 31 March 2023 the rate of tax is a flat 19% of taxable profits. The rate of tax applicable after 1 April 2023 will depend on the level of profits. The first £50,000 of profit will be taxed at 19%. Profits between £50,000 and £250,000 will be taxed at 26.5% and profits in excess of £250,000 will be taxed at 25%.

This is illustrated in Appendix 2A, again using an assumed profit of £300,000. To the extent profits are retained within Newco then these will be taxed at a lower rate than either a partnership or LLP.

Funds withdrawn from the company

Obviously you will need to draw funds from the company for your living expenses. This can be in the form of director's salary, benefits in kind, pensions, dividends, rent or interest. The decision on how profits are withdrawn will depend on the personal circumstances of the individual.

Appendix 2B illustrates the personal tax position in the event profits are drawn in the form of a small salary and the balance as a dividend. This is a typical income profile for a privately owned company. The salary is fully tax deductible against the company's profits but is small enough to avoid a personal class 1 NIC liability whilst maintaining your entitlement to state pension credits.

As can be seen when comparing Appendix 1 with Appendix 2A and 2B, the company structure actually results in a reduction in net income. This is a consequence of the interaction of corporation tax and personal income tax on monies drawn from the company. This is a simplification but to the extent all funds are drawn from the company to meet your personal living expenses it is unlikely that the company structure will offer any significant tax advantages over the current partnership or an LLP.

Incorporation and tax efficient drawings

The exercise of incorporation may offer an opportunity to significantly reduce your personal tax liability whilst maintaining your net income. This is outlined below.

Process of incorporation

The proposal would be that you form a new limited company (Newco) with a small initial share capital held in the current ratio of 60:40. You would then sell the trade and assets of the partnership to Newco at their current market value.

Newco will have no funds available to pay for the acquisition of the business and as such the sale consideration will be recorded as a substantial directors' loan from Newco owed to yourselves.

Appendix 3 illustrates a simplified opening balance sheet. This assumes that all of the partnership assets and liabilities are sold to Newco at the valuation set out in your email of 24 October 2022. You will note that the total assets of Newco are matched by a substantial directors' loan account.

The "other partnership assets" have been assumed to be transferred at market value. As the tax written down value of the fixtures and fittings and motor vehicles is zero this will result in a taxable balancing charge equivalent to the market value at the time of transfer. As this is a transfer between connected parties it is possible to elect for it to be treated as taking place at the tax written down value. This would avoid an immediate income tax charge but reduce the availability of future capital allowances in Newco.

As this is a transfer of partnership property and there is no change in the underlying ownership between the partners then there should be no SDLT charge.

Newco will receive no tax relief for the depreciation or amortisation of the property or goodwill in the company's accounts.

Personal capital gains tax liability

If the incorporation proceeds as outlined above, the disposal of the goodwill and premises to the company would crystallise personal capital gains tax liabilities. The gains are attributed to the partners in their profit sharing ratios. This is illustrated in Appendix 4. The gain arising on the sale of the property will qualify for Business Asset Disposal Relief (BADR) and the rate of tax due will be 10%. Gains arising on the sale of goodwill in these circumstances are prevented from benefiting from BADR. As such the tax rate due here would be 20%. Any allowances or personal losses will be set firstly against the gains showing the highest rate of tax.

If this transaction were to take place in the 2022-23 tax year then the capital gains tax would be payable by 31 January 2024. These are obviously material liabilities and would probably be funded by a draw-down on your loan accounts.

Capital Gains Tax mitigation and hold over reliefs

It would be possible to mitigate the above capital gains tax liability by electing to "hold over" the chargeable gains. This could be achieved in one of two ways, being "gift relief" or "incorporation relief":

Gift relief

Rather than selling the premises and goodwill to Newco at full market value you would instead either gift the assets or sell them at less than market value. To the extent the consideration was less than the original cost of the assets then this would avoid an immediate taxable capital gain.

Whilst this would remove the immediate tax liability it does have significant disadvantages: Firstly any gain is simply deferred. In the absence of any gift relief claim then Newco is deemed to acquire the partnership assets at full market value. By making a gift relief claim then the immediate gain is avoided but it is simply "rolled over" into the tax base cost of the assets in Newco. This deferred gain will crystallise in the event of a subsequent sale of assets by Newco. Secondly this would either remove or significantly reduce the level of the director's loan accounts which are critical to the planning outlined below.

Incorporation relief

In this case the whole of the partnership assets, with the exception of cash, would have to be transferred to Newco. Newco would issue shares to the partners in consideration. The capital gains arising on the transfer of the property and goodwill would be rolled over against the base cost of the new shares issued by Newco. This will reduce the tax base cost of the new shares and will result in a larger capital gain on the ultimate sale of those shares. The partnership assets are deemed to be acquired by Newco at their open market value. This does mean that the tax base cost is uplifted in the hands of Newco.

Again this would remove the immediate tax liability but would have significant disadvantages. Firstly the requirement that all assets must be transferred to Newco is highly inflexible. For example, as

noted below you may wish to retain the property in personal ownership. Secondly this would not result in a large director's loan account which is key to the planning below.

As such, we have assumed that the immediate capital gains tax liability is an acceptable cost in order to generate a large director's loan account but this can be reviewed if necessary.

Planning points using a director's loan account

The creation of a substantial director's loan account offers a number of potentially valuable tax planning opportunities.

Charging interest

Firstly, you may wish to charge Newco interest on the loan. Provided the rate of interest is commercially justifiable then this will be a tax deductible expense for the company. The interest received would be taxable income in your hands but there would be no National Insurance contributions liability. Depending on the makeup of your other income the first £5,000 in excess of your personal allowance would benefit from a 0% savings starting rate. If your taxable income falls within your basic rate tax band then you would be entitled to a further tax free savings allowance of £1,000. If you are a higher rate taxpayer then this allowance is reduced to £500.

Newco will need to withhold basic rate tax from any interest payments and account for this to HMRC. Any tax withheld is available as a credit against your personal tax liabilities.

Staged draw-down

As cash is generated in Newco then the loan account can be drawn-down tax free from the company. This can be used to supplement your taxable income and allow you to maintain your lifestyle without pushing you into higher marginal rates of tax. In addition, you will be able to protect your personal allowance entitlement by keeping your taxable income below £100,000.

The above is illustrated in Appendix 5. This results in a total net income of £195k which is significantly higher than the equivalent figure as a partnership or LLP in Appendix 1.

As the loan accounts are drawn-down then the interest charge will reduce. Based on the initial director's loan account of £1,350,000 then you could maintain this level of net drawings for a considerable period, possibly up to retirement.

Retention of the property in personal ownership

You may consider retaining the business premises in your own names. Although this would reduce the level of the initial directors' loan account I have set out below a number of reasons why this may be preferable:

Capital gains tax

By retaining the property you would avoid the capital gains tax arising on the disposal illustrated in Appendix 4.

Future rental income

If the property is retained then you could consider charging a commercial rent to Newco for the use of the premises. I understand that a commercial rent for the property would be around £28,000. The payment of rent is a tax efficient means of drawing funds from the company. The payment will be a tax deductible expense in the company and the receipt by you would be free of any NIC liability.

Any rental income received would potentially offset the reduced interest charge reflecting the lower initial directors' loan accounts.

Possible future property disposal

You have indicated that the property may be designated for residential development in the medium term and that this will result in a substantial uplift in value. By retaining the property in personal ownership this provides greater flexibility in the event of a future sale. If the property were held in Newco then any gain on sale would firstly be subject to corporation tax in the company. In the event you wanted to extract the net profit from the company by way of dividend or salary then there would be further, potentially significant, personal tax charges.

If the property is retained in personal ownership, this double layer of taxation is avoided. By retaining the property you have the flexibility to dispose of this independently of the business.

Under the current partnership structure a sale of the property along with the rest of the business would qualify for BADR. Because incorporation is treated as a cessation of the partnership then a subsequent sale of the property would continue to qualify for BADR for up to three years. If the property is retained in personal ownership for more than three years then your entitlement to BADR would be dependent on any subsequent sale taking place in conjunction with a "material disposal" of the share capital of the company. A material disposal in this context is at least 5% of the share capital. Even if this were the case your entitlement to BADR will be restricted on a time apportioned basis to the extent you have charged a commercial rent to Newco. To the extent BADR is not available then the capital gains tax rate will be 20%

Inheritance tax restrictions

In the event of your death then the whole of your interest in either the partnership, LLP or your shares in Newco should qualify for Business Property Relief (BPR). This gives a 100% exemption from inheritance tax. BPR is much more restricted where assets are owned personally and are used by your trading company. In these circumstances relief is limited to just 50% and is only available to a controlling shareholder. As Rohat will hold less than 50% of the shares of Newco this means that he would lose all entitlement to BPR on the property if it is retained in personal ownership.

Appendix 1

Tax on LLP or partnership profits post April 2023

If we assume taxable profits of £300,000 then the comparative tax for an LLP and a limited company would be as follows:

LLP:

	T Ryan		R Saj	
	£	£	£	£
Profits		178,100		121,900
Personal allowance	(0)		(1,620)	
Taxable	178,100		120,280	
Income tax				
£37,700 x 20%	7,540		7,540	
£112,300 x 40%	44,920			
£82,580 x 40%			33,032	
£28,100 x 45%	12,645			
Total tax		(65,105)		(40,572)
Class 2 NIC				
52 x £3.05	159		159	
Class 4 NIC				
£9,568 x 0%	0		0	
£40,702 x 9.00%	3,663		3,663	
£127,830 x 2.00%	2,557			
£71,630 x 2.00%			1,433	
Total NIC		(6,379)		(5,255)
Net income		106,616		76,073

The total net income is £182,689.

Appendix 2A

Tax on a limited company

Assumed taxable profits of £300,000.

		£
Profits		300,000
Minimal directors' salary	2 x £9,500	(19,000)
Employer's NIC	£9,500 - £8,840 x 13.8% X 2	(182)
Taxable profits		280,818
Corporation tax	£280,818 x 25%	(70,205)
Profits available for distribution		210,613

Appendix 2B

Personal tax on profits drawn in full from the company

(Assume on net profit split 60:40 after a salary of £9,500 each)

Director's personal tax:

	T Ryan		R Saj	
	£	£	£	£
Salary	9,500		9,500	
dividend	126,368		84,245	
		135,868		93,745
Personal allowance	(0)		(12,570)	
Taxable	135,868		81,175	
Income tax				
£9,500 x 20%	1,900			
£2,000 x 0%	0		0	
£26,200 x 7.5%	1,965			
£35,700 x 7.5%			2,678	
£98,168 x 32.5%	31,905			
£43,475 x 32.5%			14,129	
Total tax		(35,770)		(16,807)
Net income		100,098		76,938

The total net income is £177,036.

Appendix 3

Newco simplified opening balance sheet

	£
Goodwill	900,000
Freehold (including SDLT)	400,000
Other net assets	50,000
	1,350,000
Directors loans (see below)	(1,350,000)
Net Assets (ignoring share capital)	0

Appendix 4

Potential capital gains on incorporation

	Teresa Ryan		Rohat Saj	
	Goodwill	Freehold	Goodwill	Freehold
	£	£	£	£
Deemed proceeds	540,000	240,000	360,000	160,000
Base cost	(72,000)	(108,000)	(48,000)	(72,000)
Gross gain	468,000	132,000	312,000	88,000
Annual exempt amount	(12,300)		(12,300)	
Losses brought forward	(260,000)		(195,000)	
Taxable gain	195,700	132,000	104,700	88,000
CGT payable				
10%		13,200		8,800
20%	39,140		20,940	

Allowances and losses will be allocated against gains taxable at the highest rate.

Appendix 5

Illustration of net income from Newco

This assumes 6% interest is charged on the director's loan account and that £60,000 of the loan account is repaid to the directors at the year end. A dividend is voted sufficient to maximise income whilst retaining full personal allowances.

Company taxation:

		£	£
Profits			300,000
Directors salary	2 x £9,500		(19,000)
Employer's NIC	£9,500 - £8,840 x 13.8% X 2		(182)
Interest on directors' loans	£1,350,000 x 6.0%		(81,000)
Taxable profits			199,818
Corporation tax			
	£50,000 x 19%	9,500	
	£149,818 x 26.5%	39,702	
			(49,202)
Repayment of directors' loans			(60,000)
			90,616
Dividend			(69,000)
Retained funds			21,616

Personal taxation:

	T Ryan		R Saj	
	£	£	£	£
Salary	9,500		9,500	
Interest	48,600		32,400	
Dividend	41,400		27,600	
		99,500		69,500
Personal allowance	(12,570)		(12,570)	
Taxable	86,930		56,930	
Income tax:				
Interest				
Starting rate £5,000 x 0%		0		0
Savings allowance £500 x 0%		0		0
£32,200 x 20%		(6,440)		
£7,830 x 40%		(3,132)		
£23,830 x 20%				(4,766)
Dividends				
£2,000 x 0%		0		0
£39,400 x 32.5%		(12,805)		
£6,370 x 7.5%				(478)
£19,230 x 32.5%				(6,250)
Net income		**77,123**		**58,006**
Repaid loan account		36,000		24,000
Total received		**113,123**		**82,006**

The total net receipt is £195,129