

TaxZone Newthwire

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Editorial Note

Just when we had all settled down to the positive fact that the tax regime for small companies was beneficial, along came the December 2003 Pre-Budget Statement. Hidden among the published documents was what is now known as IR 591, which referred, in a succinct statement, to 'collecting the correct amount of tax from companies'.

The Chancellor and the Inland Revenue have not elaborated on this statement, with the result that taxpayers and professionals are left in a state of complete uncertainty. We have to wait until the Spring 2004 Budget, presumably, to find out what the Chancellor meant.

In the meantime it is wise to trace the development of the current regime, consider what might happen and make the necessary contingency plans.



Regards

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Incorporation Reconsidered

The current regime

In order, presumably, to encourage the small business community, tax rates for small companies have become extremely attractive in recent years. Currently taxable profits up to £10,000 are free of tax and are taxable at only 19% for the next £40,000. Subject to the National Minimum Wage, small companies can then declare dividends free of national insurance, and containing a tax credit.

The result of these measures has been to emphasise a substantial difference in the tax treatment of small companies, as compared with small unincorporated businesses. Recent years have seen the publication of numerous professional articles on the subject, including many items on TaxZone, and the recent book by Roger Jones was reviewed on TaxZone.

The tax advantages of trading as a company have been so marked that it has been 'received wisdom' to incorporate a small business. My small business manager at the local bank remarked to me in the middle of 2003 that the only new business that the bank was currently obtaining was the incorporation of existing businesses into companies, presumably on the advice of the respective accountant.

Some practitioners have suggested that all small businesses should be incorporated. Others of us have been rather more cautious (see Newthwire No. 3 of 10 June 2002 on 'The Business Structure').
<http://www.accountingweb.co.uk/item/82901/786/784/785>

However, all must be agreed that the present developments are something of a surprise.

Other issues

In retrospect the Chancellor's intending attack on small companies should not have been so much of a surprise. In year 2000 the Budget contained the infamous IR35, intended to limit the advantages of the one man or woman subcontracting business trading as a company. This was of particular irritation to the IT contracting industry, where it is effectively mandatory to trade through a company medium for commercial reasons.

Nevertheless it is uncertain just how successful the IR35 legislation has been. I have always been of the view that properly drafted contracts and facts could defeat the legislation, and this has been proved to some extent by the few cases that have come before the courts and the Commissioners. I reviewed the IR35 position in Newthwires Nos. 14

<http://www.accountingweb.co.uk/item/95784/786/784/785>

and 33.

<http://www.accountingweb.co.uk/item/116685/786/784/785>

Since then the Tilbury Consulting Special Commissioners' case has been decided in favour of the taxpayer.

<http://www.accountingweb.co.uk/item/119543/786/784/785>

It only needs a suitable case to go to the Court of Appeal and be decided in favour of the taxpayer to punch a real hole through the legislation.

IR35 was eventually followed by the somewhat farcical attack on family company situations under section 660A. As indicated in TaxZone the Paymaster General has been evasive when questioned in Parliament about the success of the Revenue's statements on this subject.

I reviewed what has transpired in Newthwire No. 36 'Family Companies; The Settlements Attack'.

<http://www.accountingweb.co.uk/item/118222/786/784/785>

The Revenue have attempted to say that they have always held the views that they are now highlighting, but this just does not stand up to scrutiny. In effect the situation where one partner to a marriage has gifted shares to the other and also 'earns' the major income of the company, but dividends are shared equally, is the sort of situation that the Revenue are attacking. As indicated on TaxZone a case is going to appeal about this issue in the very near future.

What could happen

It is conjecture to suggest what sort of imposition the Chancellor intends to impose on the small company. One suggestion has been that national insurance contributions will be imposed on dividend payments. Another suggestion made by Mark Lee, Chairman of the ICAEW Tax Faculty, is that tax credits could be withdrawn from company dividends.

It remains to be seen what happens in practice, but clearly the Chancellor and the Inland Revenue have been alerted to the very favourable small company tax regime, and do not like the consequences. Another advantage for the Treasury and Inland Revenue, if either of these measures were adopted, is that both IR35 and the section 660A 'attack' would be quietly 'dropped' without any loss of face to the Government and the Revenue.

Consequences

Supposing that the worst comes to the worst and one of the two suggested courses of action are implemented by the Chancellor, or perhaps another tax imposition not yet thought of. What then would be the consequences?

- It may be that the taxation of the small company and the unincorporated business would be restored to something like parity.
- Practitioners would then have to review advice to existing clients. Were they given the correct advice to incorporate x years ago? Will some of these clients attempt to claim professional negligence against the practice?
- I would have thought that any practitioner was immune from any suggestion of offending against professional ethics when previously advising incorporation, unless this was done rashly.
- What advice will be given to new clients now, and those unincorporated businesses still anticipating a company vehicle?
- Will future advice be to disincorporate in some or the majority of cases?

For the time being the obvious course of action must be caution. We do not know what is going to happen. However, we must be ready to take action and advise clients when something does occur – presuming that the whole issue is not a 'storm in a teacup'.

Disincorporation

It is worth considering the factors involved in disincorporating an existing small company, and returning it to sole trader or partnership status. Both Mark Lee and at least one other person have already written about this aspect.

The scenario which the practitioner might face is one where the small company client has been trading for two or three years. Trading has been successful, and full advantage has been taken of the 'tax breaks' available. The company has a healthy balance sheet, and after payment of directors' remuneration and dividends there are retained profits. Fixed assets include freehold property, plant and machinery and motor vehicles, as well as cash and bank balances.

The directors and their advisers decide that, for tax and commercial reasons, the business should be returned to personal ownership. What are the factors to be considered?

Legal and statutory issues

The directors will have to decide whether the company will simply cease trading, with work and assets being transferred out to the unincorporated business, or whether actual liquidation of the company takes place.

Liquidation or 'striking off' is governed by the Companies Acts, the procedures for which are beyond the scope of this wire, but they must be considered carefully and the appropriate advice obtained.

There are other possibilities such as the company being in partnership with a sole trader or partnership, but all these initiatives have their own complications.

Practical points

A change of business status also produces a whole raft of practical issues. Perhaps the most important one is the attitude of the business bankers. We are all now well aware of the difficulties in opening a new bank account. How will the bank react to any decision to disincorporate? Have the directors given existing guarantees and indemnities in connection with the limited company account? Are there any charges on company assets?

Other practical issues will include the notification of suppliers and customers, new notepaper and business stationery, perhaps amendments to the business website, and adjustments to insurance arrangements. Change of status may affect the business' marketing programme, and the whole exercise will be costly. Numerous other administrative adjustments will need to be made, including Health and Safety and employment law issues, a new VAT registration and PAYE scheme, and the whole corporation tax/income tax situation, which will now be considered.

Taxation issues

We now turn to the taxation issues concerned with disincorporation.

Corporation tax

Assuming that the company ceases trading, the final accounting period will be up to the date of cessation of trading. Accounts and a corporation tax return for that period will have to be filed.

An important part of the final tax computation will be capital allowances. An election should be made to transfer assets to the unincorporated business at tax written down value. Otherwise the assets will be deemed to have been transferred at full market value, with the resultant balancing allowances and charges.

The cessation of trade will accelerate the payment date for corporation tax. Unless there is post-cessation income post-cessation expenses will be disallowed, and the Revenue will, in any case, disallow the expenses of cessation.

Capital gains tax

A different situation applies where buildings and property are owned by the company, and the acquisition cost is less than current market value. For capital gains tax purposes the asset must be transferred at market value.

A major difficulty is now that capital gains tax business asset taper relief does not apply to assets held by a limited company, although it may apply to the shares of or distributions made to individual shareholders. Retirement relief no longer exists, and hold-over relief or rollover relief would not appear to be available.

Extraction of funds

However, much the biggest difficulty facing individuals contemplating disincorporation is the tax-efficient extraction of funds from the company. Supposing that the cash available reserves of a small company are £20,000, what possibilities exist?

- A straightforward liquidation to shareholders following cessation of trading and incorporating the £20,000 will trigger capital gains tax on the deemed disposal of the shares.

- A distribution to shareholders under section 209, Taxes Act 1988 may be made to shareholders prior to liquidation. Although ACT no longer exists, the grossed up equivalent of the amount of the distribution may attract higher-rate income tax in the hands of the shareholders. However distributions made in the course of dissolving or winding-up a company are treated as 'capital distributions' and are therefore chargeable to CGT (section 122, TCGA 1992)

A distribution made to shareholders during the course of a winding-up does not count as an 'income' distribution for tax purposes and therefore no tax credit is available to the recipient shareholder (section 209(1), Taxes Act 1988). The Revenue will normally treat any distribution made under ESC C16 as a capital payment.

It is therefore important to make any 'income' distribution before any winding-up, and this applies generally to the extraction of funds.

Business asset taper relief may apply to capital distributions made to qualifying shareholders. It should be recognised that once the company ceases to trade then the relevant shares become a 'non-business asset' for taper relief purposes. The situation may therefore arise where, if the distribution is made in the course of liquidation, then a calculation has to be made incorporating 'business' and non-business' periods.

Capital distributions in specie in the form of assets are extremely tax inefficient. Such transactions will form two disposals – one by the company in respect of the asset, and the other by the shareholder in connection with his shares. They will also be treated as transactions at market value (see section 17 (1) (a), TCGA 1992).

- A pre-liquidation dividend

In some instances it will continue to be beneficial to extract an income dividend before the company is wound up or struck off. The optimum income dividend/capital distribution mix will depend on the shareholders' indexed base cost and the available taper relief.

On the basis that ACT was abolished on dividends paid after 5 April 1999, the company's capacity to recover ACT is no longer a constraint on the amount of the dividend which can be paid.

If the company has surplus ACT brought forward, it will be necessary to compute shadow ACT on the pre-liquidation dividend which must be offset before the actual surplus ACT. Unless the company anticipates generating significant taxable profits during the winding-up period, for example a large capital gain on a property disposal, most if not all of the ACT surplus may be lost.

- Payment of additional directors' remuneration or bonuses, and/or remuneration to family members. The whole issue of bonus v dividend is beyond the scope of this wire, but it will be necessary to do a calculation based on the actual facts and figures of the individual case in order to produce the best tax-efficient conclusion.
- A substantial payment into an executive pension scheme. This may take the form of a 'top-up' to an existing scheme, or the company may enter into the appropriate scheme, provided this is all dealt with before liquidation or striking off.

The new business

The taxation affairs of the new business, in the form of a sole trader or partnership must now be considered.

Timing

The date of cessation of the company and date of commencement of the incorporated business must be considered carefully. As already mentioned liquidation will accelerate the date of corporation tax payment for the company.

Equally, the date of commencement and year-end of the unincorporated business are important. It must be remembered that the new business is likely to have to pay 1.5 years' tax on the first 31 January after its initial accounts year.

The incidence of overlap relief and the year-end are also important. Is 31 March or 5 April or 30 April the best year-end?

Self-assessment

The business will now be leaving CTSA and entering income tax self-assessment. That alone should not be a massive change, but benefits-in-kind and PAYE for the owners will be something in the past. On the other hand completion of personal self-assessment returns and possibly partnership returns will arise. Unincorporation brings the possibility of an Inland Revenue Enquiry into the affairs of the owners of the business.

VAT

The company VAT scheme will have to be wound up and notification made to Customs and Excise. At the same time a new VAT scheme and number will have to be obtained for the unincorporated business. Questions regarding annual accounting etc, will have to be addressed.

NIC

The owners of the business will previously have paid Class 1 contributions, and the company Class 1 and class 1A and possibly Class 1B contributions. The owner or partners will now have to notify the Revenue and commence paying Class 2 contributions. Their Class 4 contributions will become part of their half-yearly tax bill.

Conclusion

Incorporating a business is a lengthy and costly exercise. As can be seen from the above, disincorporation is likely to be just as complicated and costly.

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