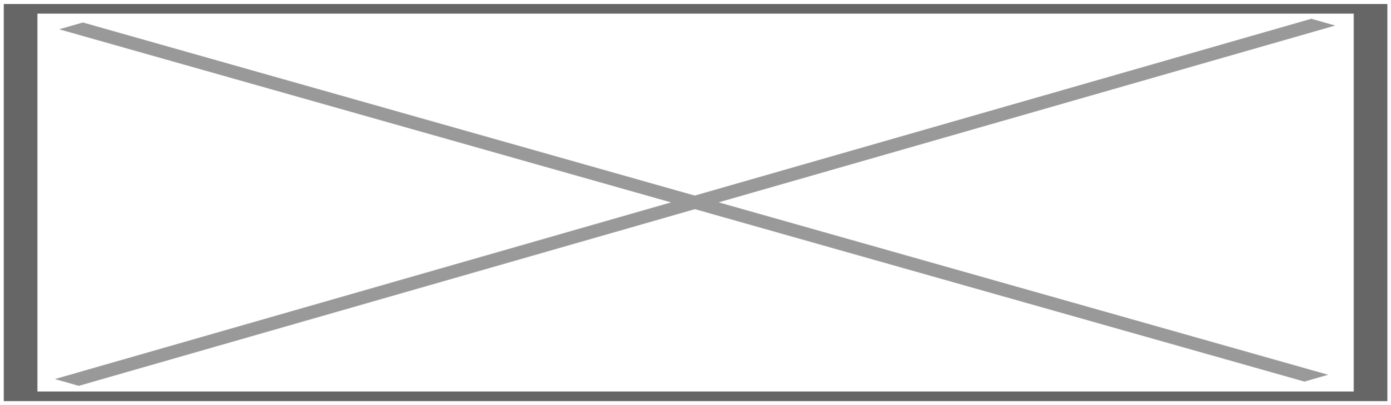
Choice of vehicle

Large Corporate OMB Tax voice



31 May 2016

Pete Miller looks at the choices to be made

Choice of Business Vehicle

One of the most important decisions that many of us make when we start a business is the choice of vehicle through which the business should be carried on. Should we form a company? Will a partnership do instead? Or should we go for some kind of halfway house with a limited liability partnership? Those are the simple answers to the question, of course, and in the past even more complex ideas, such as a limited liability partnership with corporate partners, have been quite common, because of the actual or perceived tax advantages. For the purposes of this however, we will stick to the simple structures.

As I am a tax advisor and this article is on the CIOT website it will not be a surprise that I am going to start off by considering the tax position. A company prima facie has the advantage of a lower tax rate, with corporation tax rates currently at an historic low of 20%, reducing to 19% from 1 April 2017 and 17% from 1 April 2020. This compares very favourably with income tax rates which can be up to 45%, although we do have to take into account the rates of tax on dividends extracted from the company. These have been increased, with effect from 1 April 2016, specifically to discourage tax driven incorporation. This does not mean that HMRC disapproves of companies as a vehicle for carrying on a business. It simply means that as a matter of policy HMRC do not consider that the tax payable should be a main driver of that decision.

Let us have a look at the rates of tax on corporate profits, taking into account the new dividend rates. Let us start off by assuming a company that makes £100 of profit and pays £20 of corporation tax has £80 available to distribute. If the shareholder is a basic rate taxpayer, they will pay 7.5% tax on their dividends which would be a further £6 on a distribution of £80, so that the total tax burden is £26 on £100 profits, an effective tax rate of 26%. Conversely, an individual earning similar profits as a self-employed person would be 20% Income Tax and 9% Class 4 National Insurance contributions (NIC), giving a total of 29%. So the company looks slightly more tax efficient (even though we have not taken into account personal allowances and the £5,000 dividend allowance, to keep the examples simple).

If the shareholder is a higher rate taxpayer, they will pay 32.5% on their dividends, which is a further £26 on the £80 dividend on top of the corporation tax, giving an effective overall rate of 46%. In contrast, a higher rate taxpayer who is self-employed will pay 40% income tax and Class 4 NIC (at 2% over £43,000). Again, this is a very simplistic example and suggests that, in this case, the company is slightly less tax efficient, albeit without taking into account personal allowances, etc. For additional rate taxpayers, where the rate of tax on dividends is 38.1%, the tax on an £80 dividend will be £30.40, which gives an effective tax rate of just over 50% for corporate profits whereas an income tax payer would pay 45% income tax and 2% National Insurance, so the company is, once again, prima facie slightly less efficient. If all the personal allowances and dividend nil rate were taken into account, it appears that the differences between a company and being self-employed, from a tax perspective, are only slight.

Of course, this does not take into account the fact that corporate profits that are not distributed are not taxed. So the ability to defer the income tax on dividends until the dividends are taken is a clear advantage, from a cash flow perspective, over being a sole trader or partner, where the profits are taxed as they arise, whether or not they are extracted from the business. Of course, this does not take into account the implicit threat, in HMRC's consultation document *Company Distributions* from last December, of a return to close company apportionment. (For younger readers, this was a tax that effectively taxed part of a company's undistributed profits as if they had been distributed, in order to encourage companies to distribute their profits, not retain them.)

From a commercial perspective, the main advantage of a company was always the ability to limit your liability as a shareholder. This difference was pretty much swept away in 2000 when it became possible to operate through a limited liability partnership, which has all the advantages and flexibility of partnership with the additional benefit of limited liability. The trade off, of course, is that operating through a limited liability vehicle, whether an LLP or a company, requires a higher degree of regulation, such as annual returns to Company House, and the like. Speaking personally, I have not found this degree of regulation to be particularly onerous and the reassurance of limited liability certainly makes that worthwhile.

The other feature as to the choice of vehicle is flexibility of membership. If you are a sole trader or a partnership, it is relatively easy to bring in new partners to the business, or for partners to leave. That is, a person can become a partner in a partnership, together with full access to partnership assets, etc., if that is what is required, without any obvious tax consequences at the point of joining. Conversely, to bring a new shareholder in to a company can be very difficult, particularly if they are to be given a material stake in a successful business. If they do not pay full market value for the shares, then prima facie there is a potentially very large charge to income tax and NIC, under the employment-related securities rules, effectively treating the difference between market value of the shares and what was paid for them as if it were further income. And this burden falls largely upon the company, which is responsible for operating Pay As You Earn and NIC systems. The problem is that a new person joining a company is unlikely to have sufficient cash resources to pay for the shares that they are offered. There are, of course, various statutory schemes whereby people can become shareholders more tax efficiently, but these are often inappropriate to the company's particular position, do not allow the person to obtain sufficient interests in the company, or are simply too expensive for the business to implement. So companies are relatively inflexible when bringing in new members.

Similarly, if a person leaves a company, they are likely to want to sell their shares, and pay capital gains tax. But, of course, there also needs to be a market for those shares, so either other shareholders or new external investors would have to buy them, or the company has to buy its own shares back, all of which have financial, commercial and tax consequences for the shareholders that remain behind. Obviously, when a person leaves a partnership, they will want to be able to access their undrawn profits and possibly their original capital contributions, but these matters can be dealt with far more easily by way of a partnership agreement, regulating the rate at which cash can be extracted from the business, without any further tax consequences. So, one of the major advantages of a partnership over a company is the flexibility of membership.

There are, no doubt, almost as many reasons for the decisions as to what form of entity should carry on a business, as there are different businesses. You, or your clients, may have based the decision on any number of other factors and not taken any of the above issues into account. So this article has tried to give just a small flavour of what I see are the major issues that I have come across in this context, it certainly does not purport to be exhaustive.