Winter 2014

Veterinary Matters

Guiding your practice to lifelong prosperity

INCORPORATION
ADVANCED PLANNING FOR THE CUTTING EDGE PRACTICE

Events

London Vet Show
20-21 November 2014
Olympia London
Come and visit us at stand I 84

We will be speaking in the Business Theatre, at
14.45 - 15.45 on Thursday 20 November about 'Cutting edge tax planning'.

SPVS/VPMA Congress
23-24 January 2015
Celtic Manor
Come and visit us at stand 29

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Incorporation

- Advanced Planning

The tax landscape has been changing continually over the past few years. More and more veterinary practices have incorporated and are now running their practices through limited companies. Does that make it right for every practice? No. Is it right for your practice? Possibly.

This release considers more advanced areas of incorporation. Back in our Autumn 2013 Veterinary matters (http://goo.gl/s0gzoZ0) we covered introductory details on incorporation including tax savings and basic "what to think about".

It is critical to understand the triggers that help determine whether trading as a company or having a company within your structure is beneficial for you. Your personal and practice's circumstances change over time and if these are not regularly reviewed against these trigger points, it would be worthwhile doing so.

Let's dispel one myth early on. There is no "one size fits all" approach to determining which practices would be best trading through a company.

Space dictates that what follows is not an exhaustive list, although it helps provide a guide as to the common key triggers for incorporating companies.

These are set out in the following sections:

- Profit
- Property and debt
- Purchasing a practice
- Limited liability

Profit

In recent years, standalone companies with profits above £300,000 have paid corporation tax above 20%, with 20% having applied below this level. From 1 April 2015, all companies will pay corporation tax at 20%, irrespective of their level of profits.

In a company the owners are taxed on what they extract as remuneration from the company, whether by salary, dividends, rent, interest, etc and the tax on these depends on the levels extracted. It is critical that a structured remuneration plan is put in place to ensure that the interaction of a company's and owner's tax position is as efficient as possible. This should include a proper audit trail of transactions, for example, but not limited to, dividends being physically drawn in cash and properly documented, to minimise the risk of H M Revenue and Customs (HMRC) questioning their validity. This is often overlooked.

For company owners that retain a significant degree of profits in the company, for example for reinvestment in the practice, the savings from incorporating can be significant.

By way of illustration, consider the following example:

- A company owned 50:50 by two individuals;
- Company has profit after tax of £500,000 per annum which is fully available in cash for extraction by the owners (in practice this may not be the case. In particular, you should be aware that dividends paid by a company are not permitted by law to exceed distributable reserves typically historic profits less dividends to date);
- For simplicity, assume that the owners have no other income and make no pension contributions/other tax deductible items.

The "normal" per annum savings for all owners and the company combined, compared to trading as a partnership (on which the partners would be taxed on their respective taxable profit shares, irrespective of what they draw), are estimated below under different scenarios. This assumes that the directors' loan accounts have been fully drawn down in the company (prior to that greater tax savings would be possible in this example) and remuneration is extracted by way of salary at the employer's National Insurance threshold. The balance is in the form of dividends (using the 2014/15 tax rates):

Scenario 1... each owner extracts £125,000: overall savings of approximately £33,000 each per annum.

Scenario 2... each owner extracts £75,000: overall savings of approximately £50,000 each per annum.

The level and manner in which remuneration is taken can have a significant bearing on the quantum of the tax savings. In some circumstances, remuneration can be at such a level that it is marginal for a "full" incorporation to give rise to tax savings (if at all). In such cases, it might still be beneficial to have a company in your financial structure, for example in a service company type arrangement, running alongside an unincorporated business, e.g. partnership.

Property and debt

"We often get asked as to whether a property is best owned within a company or personally by the company's owners. The answer is - it depends."

Owning property and associated debt in a company can be highly tax efficient, with the company repaying the bank debt out of profits taxed at 20% (or slightly higher as previously noted). This contrasts to an off balance sheet personal loan with personally owned property, where the cash used to repay the debt has been taxed at the corporation tax rate in the company and then again at personal tax rates on extraction from the company to service the personal debt.

Where a property is transferred into a company, there could also be a Capital Gains Tax charge. There could have been a Capital Gains Tax charge payable by the partners if the value of the property at incorporation (being the market value it is sold to the company for) was more than the original cost incurred by the original partnership. Stamp Duty Land Tax might be payable on the transfer depending on the ownership proportions of the company compared to the unincorporated practice. It can sometimes be possible to mitigate this, for example, where the partnership (but not sole trade) and company ownership proportions are the same.

Keeping property outside of a company also provides flexibility for the future. For example, if the property owners wish to retain them post-retirement and then rent them to the future practice owners as an additional income stream. This can still often be achieved by transferring property ownership from a company to individuals prior to retirement. However, this can give rise to a corporation tax charge in the company if the property has risen in value. In addition, if the owners do not have a directors'/shareholders' loan account at that time to cover the property cost, they might need to raise the finance to buy the property from the company by way of a loan, unless they raise funds from the sale of the business around the same time.

Care needs to be given to the level of any rent payable by a company to the property owners where the property is not owned by the company. Banks often insist on full market rents being paid. Having an adviser on board that can work closely with your bank to accept greater flexibility as regards rent and other matters can be invaluable.

Where full market rent is paid, this increases the Capital Gains Tax exposure for the property owners upon the potential future sale of the property up to 28% (assuming a higher rate tax payer) for the period where such a rent is paid. Where there is no rent, that period would be subject to 10% Capital Gains Tax with the benefit of Entrepreneurs' Relief (assuming the qualifying conditions are met).The sale of the property would need to be as part of the withdrawal from the business.Whilst this does not necessarily need to be at the same time as the share sale, a plan to sell the property would need to be in place at that point. A rent between £nil and full market rent would give a Capital Gains Tax exposure of above 10%, but less than 28%.

SDLT also needs to be considered where rent is paid, whether or not there is a lease. Payment of rent creates a deemed lease. SDLT is payable at 1% where the net present value of the rent payments over the term of a lease exceeds £150,000 (where there is no lease this still needs to be considered on a cumulative rent payable basis). Where there are a number of practice properties, HMRC can deem these to be linked for the purposes of this calculation which can bring forward any SDLT that might be payable to an earlier date. Liaising with your accountant closely on the rent position can potentially help to mitigate this. SDLT is a complex area and there are many factors to consider and space dictates not all of these can be covered here.

Property used in the trade that is kept outside of the company will normally qualify for 50% Business Property Relief, which means that in the event of death, the remaining 50% of the property value will form part of the individual's estate for Inheritance Tax purposes. By contrast, property used in the trade that is owned by the company will form part of the share value. Shares normally qualify for 100% Business Property Relief so long as the business has been carried on by the shareholder for at least two years (whether pre or post incorporation)."

Purchasing a practice

If the goodwill of a business is purchased by a company, then corporation tax relief may be available in the form of amortisation. This applies where the business is purchased from an unconnected third party or where the business commenced from April 2002 onwards and is being purchased from a connected party.

Example:	
Purchase of goodwill by company:	£800,000
Amortisation period:	10 years
Therefore profit deduction:	£80,000 p.a.
Tax saving, say 20% rate applies:	£16,000 p.a.

This can be highly significant and is not available for unincorporated businesses, e.g. sole traders, partnerships, LLPs, that buy the goodwill of another business.

Limited liability

Your practice's professional indemnity insurance provides a degree of protection against unforeseen claims against the practice. Trading through a limited company brings the additional benefit of the shareholders having personal liability limited to the amount they paid for the shares. It should be recognised that any directors' loan accounts are still exposed, i.e. are not covered by the limited liability.

WATCH OUT

We often see practices that have been incorporated without due consideration to the practical implications of doing so. We consider some "old chestnuts" below.

Goodwill and share valuations

"One critical area in most incorporations is the value placed on goodwill as it can impact on the level of tax savings achieved."

HMRC have recently indicated that they are looking more closely at veterinary goodwill valuations. It is therefore more important than ever that the adviser you use to value your practice's goodwill has a thorough understanding of the market place and in dealing with such valuations. HMRC Investigations can be costly and it is worthwhile considering a "Tax Investigation Service" that aims to cover the cost of professional fees in the event of such HMRC Investigations.

What might HMRC be concerned about? Generally HMRC will wish to make themselves comfortable that the value placed on goodwill is not too high (in their eyes at least) - which would create artificially high directors' loan accounts, together with associated tax savings. For those that are incorporating, you will no doubt wish to ensure that the value placed on goodwill is not too low, in order to avoid losing out on an element of the potential tax savings. It's a balancing act.

It is surprising how many practices fail to be advised that a company structure will change regarding how goodwill can be dealt with. Upon future ownership changes, e.g. internal succession, HMRC require that a commercial valuation is applied to the company's shares, including the goodwill element. The freedom that is available in an unincorporated setup as regards to how goodwill can be valued (essentially the owners can choose the valuation subject to any partnership/LLP agreement) is significantly reduced.

This is not to say that there is not scope to take account of an incoming owner's prior working contributions to the practice whilst they were an employee when assessing a buy in /retirement price, but that any adjustment to the valuation must be assessed against the need for it to be commercial. If shares are sold at a below commercial value, this can lead to significant tax charges for the incoming owner. It is essential that an experienced veterinary valuer is used for future ownership changes to avoid such associated pitfalls.

Timing and future ownership change

The timing of an incorporation is absolutely critical, as are future retirements or a sale of the practice. Entrepreneurs' Relief (which essentially results in a 10% Capital Gains Tax charge on the sale of shares) needs to be considered carefully to ensure that the qualifying conditions are met. One key point is that Entrepreneurs' Relief is not available if an individual sells their shares in the company within one year of them being held or since the company started to trade. Often incorporations see the share value of a company build up quickly following incorporation. Profits can be significantly above the level of dividends taken (where a large part of "remuneration" may be in the form of directors' loan account draws to mitigate higher rate tax). Directors' loan account draws do not affect share value, whilst dividends reduce it. If the timing of a retirement / sale is not considered carefully, this could result in Entrepreneurs' Relief not being available and significant extra tax being payable.

In a partnership / LLP, a practice might seek to take out a bank loan in the practice name to finance the retirement of one of the owners. In a company situation, this is permissible where the loan is taken out in the company to finance the repayment of a director's loan account upon retirement. However if the loan is to finance the buy out of an owner's shares (known as a Purchase of Own Shares), the company must have been trading for at least five years. There also needs to be sufficient distributable reserves to cover the share value, if the generally preferred capital treatment is to be available.

The capital treatment for Purchase of Own Shares enables the proceeds received by the retiring shareholder to be treated as capital and so benefit from 10% tax rate, assuming Entrepreneurs' Relief is available. The alternative would be for the proceeds to be taxed as income in their hands, so would be potentially subject to higher rate tax of up to 30.56% (net) of the proceeds received. There are other qualifying conditions that must be met in order for the capital treatment to be permissible. If this is not available, it might be that the remaining owners have to take out personal loans in order to buy the shares from the retiring owner. In order to repay these loans, they are likely to need to extract additional remuneration from the company, which will result in their directors' loan accounts being depleted more quickly and, ultimately, additional personal tax being paid at an earlier time.

There is generally more to consider where the owners wish to sell the practice and it trades through a company. In particular - whether the shares or the trade/assets will be sold. The level of potential purchaser due diligence may be greater where a company is being purchased. Careful planning is required in order to ensure the best tax position on a sale and to keep costs manageable. Poor advice can lead to dissatisfaction and escalating costs.

Finance

Banks and other finance providers need to be brought on board at an early stage, in particular to ensure that, where possible, there is no re-broking of the terms of any existing finance. One option is to leave the bank debt outside of the company, together with the property, which normally avoids the bank debt being re-broked, although this needs to be considered on a case by case basis with the bank.

Banks need to be fully briefed on the structure of the incorporation so that they are able to consider their position Often we see that banks have not been instructed correctly and this can lead to unnecessary angst and delays. Your adviser should help you avoid this.

Company owners often see a reduction in their own **taxable** income in a company environment (repayment of directors' loan accounts is not taxable income). This can lead to difficulties for some in raising personal finance, e.g. for a home mortgage, unless the finance provider has a complete understanding of the owner's personal and business circumstances. We continue to see a disparity of approach by finance providers - some fully understand the change in structure with incorporation, whilst others continue to take a more "tick box" approach in assessing finance applications by individuals, which can cause difficulties for those that it affects. Again, your adviser can help by explaining the rationale for the company structure to the financiers.

Insurance

It is critical that all insurance policies are reviewed, both practice and personal, to ensure that the terms of cover appropriately reflect the new structure in place. This should include (but not limited to) policies such as Permanent Health Insurance, which can easily be overlooked.

Inheritance Tax

Directors' loan accounts will form part of an individual's estate in the tragic event that they were to die. It might be possible to insure against this risk and it is worthwhile consulting with an insurance adviser.

VAT

The practice's VAT position needs to be looked at closely. Often it is simple enough to transfer the existing unincorporated VAT registration to the new company and effectively to carry on as before. However, there can be pitfalls with this approach.

If the properties from which the practice trades are owned by the practice, have not been opted to tax and property capital costs have been £250,000 or more within the last 10 years, then removing the property from the balance sheet on incorporation may trigger the Capital Goods Scheme rules.

Potentially this may result in a significant claw back of previously reclaimed VAT if the VAT registration is transferred to the company. In this case, it might be better for the property owners to retain the VAT registration, opt to tax the property and the company apply for a new one.

The future VAT position also needs to be considered. If the practice property has opted to tax and is owned outside of the company, then the property owners will need to be registered for VAT and add rent to their VAT invoices to the company. If there is any residential element to the accommodation, this also needs to be taken into account. The timing of the company and private VAT returns should be thought about, to ensure there is ideally no adverse cash flow disadvantage in terms of when VAT is paid over to HMRC on the rent and when it is reclaimed.

"VAT can be a complex area which most practice owners will need guidance on."

PAYE

Close liaison with the preparer of the payroll and the solicitor dealing with the incorporation is essential.

HMRC needs to be informed of the PAYE position, when a new PAYE scheme is setup, and when the old scheme is ceased. If this communication does not happen, it can lead to demands by HMRC where they believe they have not received PAYE/NI payments, when in fact they have been made, albeit under a different PAYE scheme in the new company structure.

Your practice's employees should review their tax codes carefully following an incorporation. We have seen instances where HMRC "resets" individual employee's tax codes to the basic tax code, rather than accounting for benefits/personal pension contributions etc. This can lead to employees under or over paying tax compared to their historic position, which then needs to be settled up. This is obviously a sensitive issue and needs to be handled promptly and proactively.

Shareholders' Agreements and Protection

Shareholders should take legal advice to ensure an appropriate shareholders agreement is put in place, your accountant should be able to help advise you on the financial aspects of this.

Also, you should discuss shareholder protection with your financial adviser to help cover the cost of buying another owner's shares in the event of their death.

Vehicles

Generally, unless a car has zero or extremely low emissions, significant taxable benefits in kind will result from a director having a "company" car and running it through the company.

The company car and fuel benefits are based on the CO_2 emissions of the vehicle, unless the car was registered before 1 January 1998.

For Small Animal practices, where business mileage tends to be lower, it can often be more tax efficient to keep cars outside of the company and own, insure and run them privately.

Please note that home to work and work to home (where work in this case is taken to be a fixed place of business) is private not business mileage for cars (such mileage for vans is not treated as private however).

Where business mileage is frequently higher, as is often the case with Large Animal and Equine work, the tax downside of running a car through a company can sometimes be more acceptable when the wear, tear and depreciation on the car is taken into account, i.e. the wear, tear and depreciation falls on the company as opposed to the individual.

More and more practice owners are considering running commercial vehicles (vans) rather than cars through a company as the taxable benefits in kind are generally significantly lower than most cars. It is important, however, to ensure that certain criteria (see below) are met in full for a vehicle to qualify as a commercial vehicle. It also depends on what makes sense practically, i.e. whether you are happy to drive a commercial vehicle. A further plus point is that with a commercial vehicle, the practice can reclaim VAT where charged, based on the business use percentage of the vehicle.

A note of caution - many retailers class vehicles as 'commercial' or 'multi-purpose' but as far as HMRC is concerned, they are still cars and are therefore not quite all they seem at first. HMRC are very strict when it comes to what vehicles are classified as vans. See HMRC's website for further details: www.hmrc.gov.uk.

Summary

Incorporation can be complex and it might seem that way without taking guidance from an adviser that understands that there is no "one size fits all" approach and that each practice has its own particular circumstances.

Having a sound appreciation of both the commercial and tax implications of incorporating, including the potential (but avoidable!) pitfalls, will stand you in good stead.

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The services we provide include:

- Accounting and bookkeeping
- Management accounts
- Business planning and practice reviews
- Tax planning advice and compliance services
- Goodwill and business valuations
- Benchmarking and profitability advice
- Advice on buying or selling a practice
- Advice on incorporation
- Partnership changes
- Payroll assistance
- Financial planning
- Sage software advice
- And more!

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Our Veterinary Team are happy to discuss matters arising from this newsletter, as well as any other matters relating to your business or personal financial affairs. Our Veterinary Team are based at our Staverton Office:

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