Winter 2012

Pharmacy Focus

Guiding you to lifelong prosperity

Contents:

HAZLEWOODS

DRIVING LIFELONG PROSPERITY

The incorporation issue

For many sole trader and partnership pharmacies incorporation can make good commercial sense. This Pharmacy Focus outlines the main advantages and disadvantages of incorporation as well as explaining the tax consequences and the other practical issues you should consider.

With personal taxes increasing and corporate taxes decreasing even if it has not previously been worthwhile incorporating it's worth looking again. For example a sole trader with taxable profits of £50,000 could, depending on exact circumstances, save more than £4,000 each year in tax and National Insurance Contributions (NICs) as a result of incorporation.

Why is now a good time to consider incorporating?

With the Government needing to raise further revenue from businesses and personal taxpayers now is a good time to ensure that you have the most efficient tax structure for your pharmacy business.

The short-term future of the 50% tax rate for individuals with income of over £150,000 is unclear. Both David Cameron and George Osborne are keen to stress that it is temporary. However with public sector job losses and pay restrictions it is thought to be politically impossible to abolish it at the moment. In fact there has been much speculation that it will remain in place until the end of this parliament which is likely to be May 2015. We may hear more about the future of the 50% tax rate in the Budget on Wednesday 21 March.

As well as the 50% tax rate, other recent tax changes include the restriction of the personal allowance for those with incomes of over £100,000, increased NICs and falling corporation tax rates. Looking at the combined impact of all these changes certainly means that it is worth reviewing whether or not incorporation is right for you.

Incorporation could save you significant tax, but is it right for your pharmacy?

There is no hard and fast rule when incorporation will be beneficial to you as it depends on many factors including your personal circumstances. To establish whether you would save tax by incorporating requires a crunch of the numbers. With fluctuating rates of both income tax and corporate tax in recent years the calculations can be complex and for lower profit levels the best structure for tax purposes can change from year to year.

Basic rate taxpayers and incorporation

For a sole trader paying basic rate tax it is unlikely that the tax savings from incorporating would make it worth while. This is because of the additional compliance costs and formalities associated with the formation of a company. See table 1 for a comparison of the tax and NIC burden of a sole trader and a limited company for 2011/12 without enhanced remuneration planning.

Table 1 Profit	Sole trader £	Company £	Saving £
10,000	885	586	299
20,000	3,785	2,586	1,199
50,000	13,463	9,206	4,257
100,000	34,463	29,206	5,257
150,000	58,453	52,302	6,151
200,000	84,453	75,158	9,295

Table showing the tax and NIC burden of a sole trader and limited company for 2011/12.
The calculations assume the company makes a 100% profit distribution and pays a salary equal to the employer NIC threshold.

High incomes and incorporation

For a sole trader paying tax at 50% (or even the marginal rate of 60% which applies to income between £100,000 and £114,950 because of the gradual withdrawal of the personal allowance) limited companies can be extremely tax efficient. The potential savings will depend on how much the individual draws and how much they leave in the company. For example for a sole trader with profits of £150,000 who is able to retain £75,000 of the profits within the business incorporating would save £28,000 per year (as opposed to £6,151 if all the profits are withdrawn from the company).

Consider the future

Before incorporating it is important to consider what will happen to your business profits and your cash requirements in the future. It is also important to anticipate future tax rate changes. With the main rate of corporation tax due to reduce to 23% from April 2014 and the small companies rate at 20%, will the rates converge in the next few years and what will be the rate? As mentioned earlier the 50% additional rate of income tax is only a temporary measure, but when will it be withdrawn?

Other factors to consider

Assuming you would save tax by incorporating here is a summary of the other main advantages and disadvantages of incorporation.

Advantages

- Shares in a trading company can be gifted to other family members enabling wealth to pass to future generations. Such a gift should generally not be liable to Capital Gains Tax (CGT) or Inheritance Tax (IHT);
- Dividend income can be received by family members not involved in the business;
- It may be easier to obtain finance from banks since a company can give a fixed and floating charge over its assets whereas this is not an option for individuals;
- Directors/shareholders have limited liability and as such are protected against trade creditors. However, this limited liability is restricted, for example
  - Directors will be liable for losses to creditors resulting from illegal trading;
  - Directors/shareholders may be required to give a personal guarantee for company borrowings;
  - Liabilities outstanding at the time of incorporation will remain the liabilities of the partnership/sole trader.

Disadvantages

- The additional compliance costs of preparing statutory accounts. Also these accounts are available to the public including competitors;
- There is potentially a double tax charge if the company sells assets and the shareholders wish to extract the funds from the company. This is because the company is liable to corporation tax on the sale of its assets and the shareholders have a tax liability on any funds paid out to them;
- There are more PAYE and benefit in kind formalities with directors and employees of a company. There are also cash flow implications as PAYE is paid sooner than income tax by sole traders and partners;
- If tax and NIC savings are achieved by paying a small salary to shareholders with the balance being paid as dividends, this will reduce the scope for pension provisions.

The potential tax savings of incorporation are only one of the issues to consider. Before taking the plunge and incorporating you need to think about all the tax and non-tax issues of incorporation.

Remuneration planning could save you even more money

The tax savings are not just from the initial transfer of your business to a company. Other savings can be achieved through basic remuneration planning, the introduction of your spouse into the company, the use of loan accounts, property rent and the structure of your borrowings. These tax saving ideas are discussed in more detail below.

If your business is already incorporated it is worth reading on to see if there are any further tax savings you could make.

Basic remuneration planning

As an unincorporated business NIC is payable on your annual taxable profits for the business period.

Once incorporated there can be significant NIC savings by structuring your remuneration in the company in the most tax efficient manner, by paying remuneration through a mixture of:

- Dividends
- Basic salary (under the NIC threshold)
- Rent on the pharmacy premises if owned (see below)

No NIC is payable on the above types of remuneration and therefore these are the most tax efficient ways to remunerate the owner from the company.

Table 2 illustrates the tax savings that could be made by someone incorporating with business profits of £100,000 and only needing to withdraw income of up to the basic rate tax band.

Table 3 shows the potential savings over a three year period taking into account the tax savings that can be made on the sale of goodwill to the company. It assumes that goodwill is 80% of the turnover.

Table 2 Annual business profits of £100,000 - One owner

	£
Company profits	100,000
Less director's salary	(7,072)
Less extra professional costs	(750)
	92,178
Corporation tax on profits £92k @ 20%	(18,436)
Distributable profits	73,742

- If dividends were then paid to the owner to utilise the remaining basic rate tax band after salary, the total tax saving compared to a sole trader on an annual basis would be:

15,000

Table 3	Business Profits £100k	Business Profits £150k	Business Profits £200k
Cumulative net savings over 3 years	£39,000	£60,000	£104,000

Use of loan accounts

Being a sole trader you will be used to having a capital account. On incorporation this capital account will be transferred to the company and will be included as a loan from you to the company, called a director's loan account (DLA). The DLA can then be used to draw funds from the company tax free up to the value of the loan fund.

Upon incorporation the company will usually purchase goodwill from you at market value, the payment for which can be credited to the DLA.

- At the point of purchase, a Capital Gains Tax (CGT) charge will usually be triggered, potentially at 10% (see below), but this will enable you in the future to withdraw money from the company tax free. Maximising the value of goodwill at the time of incorporation will increase tax savings in the future.
- With the benefit of Entrepreneurs' Relief, CGT is currently at the lowest rate for some years. With the lifetime allowance under Entrepreneurs' Relief at £10 million it enables most pharmacy owners to benefit from this lower CGT rate of 10%.

Property

Consideration should be given to not transferring the property on incorporation (or if you are already trading through a company you should consider transferring the property from the company into a pension scheme). Significant tax savings can be made through paying rent on the premises and the property provides a good basis for retirement planning. A solicitor should be consulted in relation to the creation of a lease on the premises. You will need to consider the implications on Entrepreneurs' Relief.

Borrowings structure

Due to the lower corporation tax rates compared to personal tax rates, further tax savings can be made if there is debt involved. If the debt is in a company then the company has to retain funds in the company to repay debt.

If the borrowings were within an unincorporated business, personal higher tax rates are between 42% and 52% this will leave between 58% and 48% to repay the loans. However, within a company where the corporation tax rates will be between 20% and 26%, it means that there is a maximum of 80% to repay debt. Therefore, there is effectively a 22% saving.

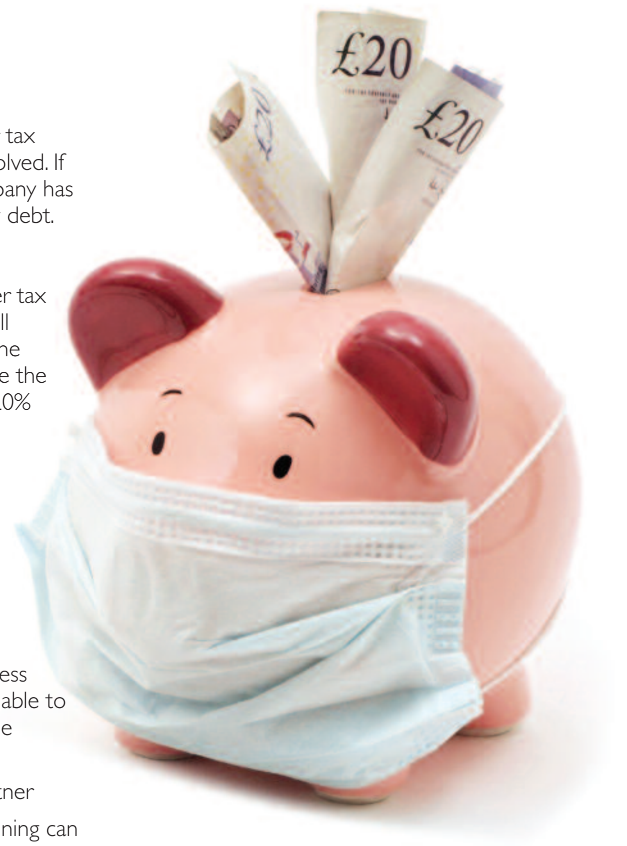
Introducing spouse/civil partner to maximise benefits of incorporation

Following incorporation or if your business is already incorporated you may still be able to structure your remuneration through the company even more efficiently.

- Low or non earning spouse/civil partner

  Through a company "family" tax planning can be enhanced. If you have a spouse/civil partner with earnings in the basic rate tax band and you are a higher rate taxpayer (ie 40% or more) then further tax savings could be made. This could be through:

  - Appointing your spouse/civil partner as a director and paying them a salary based on their contribution to the business
  - Transferring shares to your spouse/civil partner and paying them dividends
  - Transferring your DLA to your spouse/civil partner and paying interest



By both spouses/civil partners utilising their basic rate tax bands instead of one person using the higher rate tax band significant savings can be made. If further funds are required above the basic rate tax band then the DLA, can be used to avoid paying higher rate tax.

If both spouses/civil partners own shares in the company, then subject to the qualifying conditions, the couple could make use of both spouses/civil partners £10 million lifetime Entrepreneurs' Relief limit.

Further savings from introducing your spouse/civil partner

If you bring your spouse/civil partner into the company as a director and a shareholder, based on the example in tables 2 and 3, further savings could be made.

You should consider the total tax benefits of incorporation and bringing your spouse/civil partner into the business. The potential tax savings over a three year period, excluding any further savings from rent being paid to the owner, are as shown in tables 4 and 5.

Savings between unincorporated business and the company are after taking into account the CGT payable on the goodwill transfer and increased professional fees.

Remuneration in excess of the basic rate band

As stated above if further funds are required above the basic rate band of approximately £43,000 the DLA can be used. Alternatively income could be distributed to the pharmacy owner and their spouse/civil partner up to £100,000 each with exposure to higher rate tax at 40% but not at the effective tax rates of 50% and 60%.

Table 4 Annual business profits £100,000 - Two owners

	£
Company profits	100,000
Less directors salaries	(14,144)
Less professional costs	(1,000)
	84,856
Corporation tax on profits £85k @ 20%	(16,971)
Distributable profits	67,885

- If dividends were then paid to both shareholders to utilise the remaining basic rate tax band, after salary, the total tax saving compared to a sole trader on an annual basis would be:

16,000

The example does not take into account the use of the DLA to enable further withdrawal of funds above the basic rate tax band tax free.

Table 5	Business Profits £100k	Business Profits £150k	Business Profits £200k
Cumulative net savings over 3 years	£81,000	£134,000	£185,000

Other tax implications of incorporation

Income tax

The incorporation of a business will result in a deemed cessation of the old business and, depending on the date of incorporation, may lead to more than twelve months' profits being assessed in the final year of assessment, subject to overlap relief. It is important to assess future profits and cash flows before deciding a date for incorporation.

Any unrelieved trading losses from the final 12 months of trading as an unincorporated business may be carried forward and set off against directors' remuneration and dividends received from the company (assuming the goodwill is not sold to the company and subject to certain conditions).

Capital allowances

Balancing charges can arise if the market value of plant and machinery used in the business is worth more than their tax written down value. In this situation an election can be made to transfer any assets at tax written down value rather than crystallising a tax charge in the final period before incorporation.

CGT

Incorporation is treated as a disposal of the business at market value for CGT purposes. CGT usually arises on the disposal of freehold or leasehold premises, fixed plant and machinery and goodwill. Goodwill acquired by a company on or after 1 April 2002 is normally dealt with under the Income Tax legislation rather than the CGT rules.

It is possible to incorporate without triggering a CGT liability. There are reliefs which can be used to defer the gain on incorporation, although any deferred gain may become chargeable on any subsequent disposal of the new company's shares or assets.

The decision about which CGT deferral route to choose will depend on what assets are transferred to the new company and future plans.

VAT

Providing certain conditions are met the transfer should qualify as a "transfer of going concern" for VAT and so no VAT will be charged on the transfer.

Stamp Duty and Stamp Duty Land Tax

Stamp Duty Land Tax (SDLT) will apply to the transfer of UK land and property (including leases) on incorporation. No duty is charged on the transfer of debts, goodwill, intellectual property or assets such as plant and stock.

The practicalities of incorporation

Some of the administrative issues which you should consider include:

- If you are transferring the business from a sole trader or partnership to a company you will need to:
  - Work with a solicitor to deal with documentation such as business transfer agreement, articles of association, shareholders agreement, leases etc;
  - Complete the relevant forms to change the pharmacy registration including transfer of ownership and nominating a superintendent pharmacist.
- The creation of the company brings with it more administration. However, there is no requirement for an audit as long as turnover and gross assets are below the £6.5 million and £3.26 million threshold respectively. In addition the accounts need to be filed at Companies House each year within nine months of the year end. The level of disclosure is not significant but it is clearly greater than at present where no financial information enters the public domain.
- You will need to create different stationery for the new company to include on the letterheads:
  - the limited company's full name together with any trading name
  - registration number
  - place of registration
  - registered office.

Invoices must contain all of the above information together with the VAT registration number.

- You will need to make appropriate alterations in telephone directories, advertising literature and websites.
- You will need to notify customers, suppliers, hire purchase/leasing companies, the DVLA, utilities and insurance companies of the change.
- If there are employees then the new company will need to honour the terms and conditions of existing employment arrangements. Legal advice should be sought about the Transfer of Undertakings (Protection of Employment) Regulations (TUPE).

What next?

From the articles within this Pharmacy Focus it can be seen that using a company for your pharmacy business can save significant tax. The potential savings will depend on:

- Profit levels
- Number of owners
- "Family" income levels
- Personal circumstances
- Debt levels

Given the higher income tax rates and lower corporate tax rates and the uncertain economy there is no better time to review your overall tax plan for the future.

If you would like to discuss incorporating your pharmacy business or improving your remuneration planning please contact either Phil Swan or Richard Pontin-Medes on 01242 680000.

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- Buying a pharmacy
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