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The best of both worlds?

Julie Butler follows up her article last month with a look at how to use incorporation to try and maximise retirement relief.

Last month's article on Going Going Gone ... Retirement Relief emphasised the practical tax planning point of looking at how retirement relief can be taken advantage of before it finally goes. There are those who would argue that the retirement relief is now so relatively small it is not worth bothering with. For a lot of small businesses, particularly with a large number of partners, retirement relief can still be extremely useful.

One angle deliberately not covered in detail by that article was that of incorporation and being able to claim retirement relief on incorporation. The emphasis was very much on farming and there can be distinct disadvantages for farming and incorporation. For example, farming does not qualify for EIS, there is no business asset taper relief in a limited company and therefore it is not appropriate to have a transfer of assets which could appreciate considerably in value if held within the limited company, etc.

It is now worth focusing on the small non-farming sole trader or partnership who are wanting to effectively have the best of both worlds, ie take advantage of the retirement relief advantages before they disappear while also taking advantage of the current advantages of incorporation.

So what are the advantages of incorporation?

There are some who would say that the problem with the recent Budget is that they have seriously favoured the incorporated company and have done little for sole traders and partnerships. While others are lobbying, perhaps it could be a case of if you cannot beat them then you should consider joining them.

What makes incorporation more attractive now than possibly ever before? These appear to be:

- limited liability;
- no need for an audit if turnover under £1 million, suggested increase in turnover to £4.8 million;
- improved accountancy software makes the accounts that have to be filed at Companies House easier to produce and accountants able to prepare the final product for filing at Companies House with less aggravation than previously to a point that the accountancy costs of a partnership with a partnership tax return and the complexities of partnership capital accounts, etc can give very little cost differential between partnerships and companies;
- a favourable dividend route for extracting money from the trading vehicle without National Insurance problems;
- the ability to spread the ownership through the family and through the tax band;
- the ability to raise external finance without losing control and without incurring the problems of say joint and several liability of the partnership;
- use of the Enterprise Investment Scheme as a way of attracting outside capital;
- the Budget 2002 nil rate band for corporation tax combined with the previous measures to make corporation tax levels low;
- the favourable corporation tax rates for monies left in the business compared with self assessment whereby high rates of tax are paid for profits of the business irrespective of whether they have taken them or not and that payments on account basis makes this even more punishing;
- the ability to offer share option schemes for staff rewards;
- the ability to give senior management status without necessarily having to give business ownership away through the role of director; and
- the ability to allow employees to have some ownership of their business while being able to protect minority shareholdings.

There are other advantages which make incorporation of an existing sole trader business very attractive. When a sole trader or partnership incorporates they effectively sell the old business to the new limited company. This is the transfer of a going concern and the appropriate elections under the TCGA 1992 may be applicable.

The incorporation of an existing business with balance sheet purchased goodwill can be very efficient under the current tax rules. The sole trader or partnership can sell their already held goodwill to a new business, either elect to transfer it as a going concern without any capital gains tax now, or even pay 10 per cent capital gains tax through the business asset taper relief claims and therefore be able to draw down tax efficient cash from the new limited company in the form of goodwill. There are strict criteria to be met by the company and the trade and the capital gains tax position must be viewed carefully. It is also at this point that retirement relief can be claimed against the gain on the disposal of goodwill.

In practice, a small sole trading business and partnership might not actually have that much of an asset to sell against which retirement relief can be offset. It could be that the only relevant asset is that of goodwill. Again this raises a practical tax planning point because the writing down of goodwill for tax relief purposes has become more beneficial following the changes introduced in the Finance Act 2002. A practical example could be a sole trader in his or her fifties who has built up a business with a good income stream with no real capital value other than the goodwill in the business and who wants to seek incorporation. It could be that the incorporation would give a lot of other benefits such as the family would like to own the business and they would like to buy it through the vehicle of the limited company, thus buying the goodwill from the sole trader. The limited company should be able to write down the goodwill for tax and the disposal of the goodwill should be able to be eligible for retirement relief. The spreading of the ownership of the new business could mean greater use of personal allowances and tax bands and spreading the income stream effectively while giving all the advantages of incorporation.

The question over partial incorporation and therefore the possible loss of retirement relief must be considered. Farming cases such as *McGregor v Adcock* give guidance, as do the Inspector's Manuals CG63530 to CG63540. There is a temptation to incorporate part of a business to obtain the best of 'both worlds' but this could lose the right to retirement relief. The key point for arguing there is a claim for retirement is that there is a disposal of part of a business, not a disposal of assets. The wherewithal to carry on the trade has 'to leave the individual'. The best quotes come from Rowlatt J in *Graham v Green* (9 TC 30a) 'For retirement relief to be due the whole of those activities must cease when the relevant asset or assets are disposed of. By contrast, if an asset or assets have been sold but no particular activity or set of activities disappeared with the asset disposal, it cannot be said that any part of the business has been disposed.'

So what are the disadvantages of incorporation?

- Currently an audit if turnover goes above £1 million.
- The punishing benefits in kind on motor vehicles.
- No business asset taper relief within the limited company.
- Limited companies are more difficult to close down than just ceasing to trade as a sole trader.

There are, of course, ways round the disadvantages of the incorporation such as more than one company to keep below audit thresholds without incurring a group structure. Ensuring that vehicles that have low benefits in kind such as twin cabs and vans are used in the limited company or making sure that the fixed profit car scheme is used for motor expenses. With regard to the disadvantage of non-business asset taper relief, although the assets within the limited company do not attract business asset taper relief the shares of the company itself may do. It can be appropriate that the main trading assets would be subject to capital gains tax, such as freehold property and buildings, are left out of the limited company so that in the hands of the individual they do qualify for business asset taper relief provided they qualify as a business tenant.

This can also have the advantage that when there is a problem within the limited company the assets are outside and protected and the limited company absorbs the risk itself. There is, of course, the disadvantage that assets held outside the limited company only qualify for 50 per cent inheritance tax relief as opposed to 100 per cent, but this is a risk that has to be taken.

There are undoubtedly still advantages of the sole trader, particularly the whole business asset taper relief angle and there are also advantages of the trust. The practical planning point is that now is the time to look at business structures and to see how incorporation, the limited liability and use of EIS which was mentioned can be taken best advantage of. For example, under EIS outside investors can immediately obtain a 20 per cent income tax relief, they can have a tax free gain if the conditions are met and the shares are held for the required three years and if the venture fails, they get the capital gains tax loss.

The overall practical tax planning point has to be that incorporation and a review of structure should not be overlooked. The current unfashionable trading vehicle is that of the partnership. With having to prepare partnership tax returns, the joint and several liability, the complexity of having to draft a partnership agreement compared with a standard shareholder's agreement and the complexity of changing around ownership structures which can be so easily facilitated through the transfer of shares.

Time is running out and from a practical viewpoint everyone knows that tax planning cannot be looked at in isolation, it has to be looked at in the round and clients must understand all the consequences and complications of the advice. In order to ensure that the client does have the full knowledge of the use of retirement relief, understanding incorporation, yet having this sorted out by 5 April 2003 could be quite demanding for the practitioner. Incorporating any business does include practical considerations such as lease agreements, and hire purchase arrangements and it raises a large number of other practical tax points, including: transfer of the VAT registration; transfer of the going concern; whether or not the vehicles should be included in the limited company in view of the very high benefit in kind situation; trying to avoid including assets in the limited company which could produce a high capital gain because of the unavailability of business asset taper relief within a limited company; etc, etc. This does, however, present some excellent tax planning opportunities which should not be overlooked.

The best of both worlds can be achieved, taking advantage of retirement relief before it goes and all the current tax advantages post the 2002 Budget, but this is not something that should be undertaken lightly.

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