

Introduction

Starting a business is a major step for anyone. People contemplating going into business probably have a business idea that they believe they can turn into an income stream or a skill that they can offer.

Working for oneself can be very rewarding and profitable. You are your own boss, you can normally choose where and when you work and fit work around your family and other interests and commitments.

However, it can take a lot of hard work, especially in the early stages, and it can be risky. Not every business succeeds. Even if a person does not invest a great deal of money in starting up the business, if that business fails, there is still a loss of the money that might have been earned by working as an employee instead. Even if your business is profitable, there is no guarantee of a set amount of income coming in each month.

Whether a business succeeds or not may be affected by external economic or market factors that are difficult or impossible for the businessperson to control, but there are several steps an individual can take to increase the likelihood of the business's survival. The preparations made and the foundations put in place at the beginning of the business are very important.

This section briefly describes some of the main tax and financial considerations in starting an unincorporated business. A person intending to start a business must also:

- Conduct a thorough review of the market.
- Make forecasts of income and expenditure and turn them into a business plan.
- Obtain any necessary finance.

These matters are not covered in this section.

Trading vehicle

The first decision is whether to set up as a sole trader, partnership, or limited company. Sole traders and partnerships are unincorporated businesses. There are other business vehicles, but they are rarely used for a new business.

A limited company has several advantages, but also some drawbacks and additional costs.

Selecting the right trading vehicle from the start will avoid the problems and costs of incorporating or disincorporating. But it is not always easy to decide, because it might be difficult to forecast how the business will develop. Sometimes the best policy is to start as a sole trader or partnership and incorporate later, when the business is profitable.

This is also the best advice for anyone who is uncertain which is the best vehicle. Tax legislation makes incorporation far less costly than disincorporation.

Advantages and drawbacks of a limited company (excluding tax)

The taxation of limited companies is very different from the taxation of unincorporated businesses. Tax is dealt with in the next section. This section covers the other issues.

Limited liability

Limited liability is often cited as an important benefit of incorporation. After they have paid for their shares, the members of the company have no further liability to contribute towards debts incurred by the business.

However, limited liability might not provide complete protection from the company's debts.

- Directors must beware of knowingly incurring debts that they have reason to believe the company will be unable to pay. This could result in the directors facing legal action for wrongful or fraudulent trading, and can lead to disqualification as a director. In a liquidation, the court could order a director to contribute to the company's assets if there is evidence of wrongful or fraudulent trading.
- Limited liability provides relatively little protection for shareholders who are also directors if banks, other providers of finance or trade creditors require personal guarantees. Banks in particular might require loans to be secured on a director's personal assets.

Continuity of management

The management of a company might be separate from its ownership. Management of the business can then continue in spite of any changes in shareholders. Employees can be promoted to senior management positions without necessarily holding any shares in the company. They can also be given shares as an incentive.

Access to funds

Some suppliers and providers of finance might prefer to deal with companies rather than with individuals or partnerships because:

- A company can be sued as a separate entity.
- A company has continuity of management.
- Companies can give security for borrowing by means of a 'floating charge' over the whole of their assets. This is not available to a sole trader or partnership.

Conversely, some creditors might be happier dealing with sole traders or partnerships, which do not have the protection of limited liability.

Several financial institutions offer finance to companies at various stages of development. This is normally referred to as venture capital. Prominent among them is 3i plc (formerly Investors In Industry), which typically offers packages of loan and equity capital to smaller companies.

One drawback of corporate status is that a private company cannot invite the public to subscribe for its shares or debentures. If it wishes to do this, it must re-register as a public limited company (plc). This imposes additional formalities and more constraints on its activities.

- A public limited company must have an issued share capital of at least £50,000.
- At least 25% of the nominal capital and the whole of any premium arising on the issue of the shares must actually be paid in cash or some other consideration.
- Public companies have a shorter period in which to file accounts and higher late filing penalties than private companies.

Venture capital schemes

The enterprise investment scheme (EIS) gives individuals tax relief at 30% (20% before 6 April 2011) on investments up to £500,000 a year in qualifying companies. Individuals can also defer capital gains tax (CGT) liability by making EIS investments, resulting in initial total tax relief on an investment of 58% (30% income tax plus 28% CGT) for higher and additional rate taxpayers and 48% (30% income tax plus 18% CGT) for basic rate taxpayers.

The main conditions for EIS relief are, very broadly:

- Companies must have gross assets of not more than £7 million before the issue of EIS shares and not more than £8 million immediately afterwards. They must not have a stock exchange listing but can be listed on the Alternative Investment Market (AIM).
- The company must exist mainly to carry on a qualifying trade in the UK. Property development, financial activities, leasing and operating hotels or nursing homes are among the trades that do not qualify.
- The rule that the trade is carried on in the UK is due to be changed. From the date of Royal Assent to the autumn 2010 Finance Act, the company will instead need to have a 'permanent establishment' in the UK. A permanent establishment is a fixed place of business or authorised agent acting on behalf of the company.
- All the funds raised by the issue of EIS shares must be used for the purposes of the trade within two years of the later of the date of issue of the shares or the date the company commences trading.
- The company must not have raised more than £2 million under the EIS (and similar schemes) in the 12 months up to the investment.
- The company must have fewer than 50 full-time employees (or their equivalent) when the EIS shares are issued.
- The investor must normally hold the shares for at least three years, after which any gain on their disposal is exempt from tax.
- Any losses on the disposal of the EIS shares qualify for income tax or CGT relief.

For income tax relief, the investor must not be connected with the company, but can in limited circumstances become a paid director.

The Government has announced three changes to these conditions that will take effect from 6 April 2011 provided the EU grants state aid clearance for them.

- Individuals will be able to get income tax relief on up to £1 million of EIS investment a year.
- The qualifying company size limits will rise to 250 employees and £15 million of gross assets.
- The annual amount that can be invested in a company under the EIS (and similar schemes) will rise to £10 million.

Venture capital trusts (VCTs) are listed companies that invest in unlisted trading companies. An individual who invests in the shares of a VCT receives income tax relief of 30% on investments up to £200,000 a year and spreads the investment risk among several companies. However, investments cannot be used to defer CGT liability. Dividend income is tax-free, although the tax credit cannot be repaid.

For further information on the EIS and VCTs see the separate topic 'Enterprise Investment Scheme and Venture Capital Trusts'.

Drawbacks

Apart from the costs outlined, trading as a limited company has some other disadvantages.

- The flexibility of an unincorporated business is lost.
- Companies must comply with Companies Act regulations.

- The obligation to file annual accounts with the Registrar of Companies means that the accounts are open to inspection by third parties. Small and medium-size companies, as defined by the Companies Act, can file abbreviated accounts, so that some information that could be useful to competitors, such as gross profit margins, does not have to be revealed. Sole traders and partnerships (other than limited liability partnerships) do not have to file any information.
- Although the shareholders as a body can exercise effective control over the company's affairs, they cannot apply its assets to their personal use, nor can they withdraw funds at will.
 - Payments to shareholders are restricted to such dividends as it is prudent to declare.
 - As a general principle, loans by a company to its directors are prohibited by the Companies Act 2006 unless the approval of the members is obtained. There are a number of exceptions to this provision, for example, loans up to £50,000 for the purpose of enabling the director properly to perform his/her duties and other loans up to £10,000.

A case was reported where crooks 'stole' a company by filing forged forms at Companies House changing the directors. They were then able to carry out fraudulent transactions on the back of the company's history and credit ratings, unknown to the company's true directors. While this is rare, directors should be aware of the risk.

Directors can protect their companies themselves from this type of identity fraud by registering to file documents online and signing up to protected online filing (PROOF). Companies House will then accept changes of address and directors' details only if they are filed electronically (which requires security codes).

Tax considerations

Companies pay corporation tax whereas individuals, whether sole traders, partners or directors, pay income tax.

- The corporation tax rate for companies with small profits is currently the same as basic rate income tax. However, the small profits corporation tax rate covers a much larger amount of profits than the income tax basic rate band, so the comparison is often between 20% corporation tax and 40% or 50% income tax.
- National insurance contributions (NICs) on directors' remuneration and on sole trader and partnership profits also have to be taken into account.
- Whether incorporation saves tax overall depends on the level of profits, how much of the profits the company pays out and whether it does so in the form of dividends, salary or a combination of both.
- At low levels of profit, incorporation might not save tax and even if it does, the administrative costs and additional compliance might make it not worthwhile.
- In general, the corporate structure provides more flexibility and planning opportunities, especially with the salary levels that can be set for the owner/managers. However, national insurance complicates the situation.
- Small and medium-size companies can get tax relief on 200% of qualifying research and development expenditure. This is expected to rise to 225% from April 2012.

- Companies can get tax relief for expenditure on intellectual property, goodwill and other intangible assets.
- There are significant differences in how tax is calculated on disposals of business assets and on the business itself.

National insurance

NICs for an employee or director is a great deal more costly than for a sole trader or partner. Although it entitles the employee to greater state benefits, these might not be worth the additional cost. Changes to the state pension expected to take place in 2015 might also reduce the advantage of paying employee's national insurance contributions compared to the lower contributions paid by self-employed people, but the full effect of the new arrangements is currently unclear.

- A sole trader or partner pays two classes of NIC:
 - Class 2, which is a flat rate of £130.00 in 2011/12.
 - Class 4, based on profits. The rate in 2011/12 is 9% of profits between £7,225 and £42,475, giving a maximum of £3,172.50, plus 2% on all profits above £42,475.
- An employee's earnings are subject to Class 1 NIC:
 - The employer pays 13.8% on all earnings above £7,072 a year without a ceiling (2011/12).
 - The employee pays 12% on remuneration between £7,225 and £42,475, giving a maximum of £4,230.00, and 2% on all remuneration above £42,475 (2011/12).
- Even on a fairly modest salary of £40,000, the Class 1 NIC (employer's and employee's) of £8,477.06 is far higher than the Class 2 and 4 NIC of £3,079.75 on equivalent profits. The fact that employer's NIC is deductible against corporation tax does not go far to mitigate the cost.
- The employer is also liable to pay NIC at 13.8% on the value of any benefits in kind, such as medical insurance and company cars.

Many companies can avoid NIC by paying out profits to director/shareholders as dividends instead of remuneration, whereas sole traders and partners cannot do this. Dividends can be quarterly or even monthly. However, there are difficulties and careful planning is necessary.

- Dividends normally have to be paid pro rata to all shareholders, although it is possible to have different classes of shares with different dividend entitlements. This is of course not a problem for small businesses with only one director/shareholder.
- Dividends are not included in earnings for pension scheme contribution purposes.
- Combining dividends with a salary of at least £102 a week (£5,304 a year) in 2011/12 gives entitlement to those state benefits available only to employees, with little or no NIC cost.
 - No NIC is payable where the salary is between £102 and £136 a week and only employer's NIC (and not employee's NIC) is payable on a salary between £136 and £139 a week.
 - Salary between £5,304 and £14,400 a year will accrue benefits under the State Second Pension (S2P) as if the salary were £14,400.
- The saving achieved by paying dividends instead of remuneration is lower for companies with profits of more than £300,000 than for companies with profits up to £300,000, if higher and additional rate income tax and corporation tax are taken into account as well as NIC. This is because of higher corporation tax rates.

- Under company law, dividends can broadly only be paid out of accumulated profits. A company that has made losses in the early years might not be able to pay dividends.
- Personal service companies (commonly known as IR35 companies — see the separate topic ‘Personal service companies’) cannot avoid NIC through dividends. These are companies that provide the services of one or more individuals under a contract such that if the worker had contracted directly with the client under the same terms, the income would have been taxed as employment income under the rules that determine the boundary between employment and self-employment.

For more information on national insurance, see the separate topic ‘The taxation of sole traders’.

Rates of tax on profits

The rate of corporation tax on company profits is generally lower than the rate of income tax on individuals.

- There are in effect three corporation tax rates.
 - Companies with profits up to £300,000 pay tax at 20% (the small profits rate).
 - Companies with profits between £300,000 and £1,500,000 pay 20% on the first £300,000 and an effective rate of 27.5% on the profits in excess of £300,000.
 - Companies with profits of £1.5 million or more pay tax at 26% (the main rate).
- From 1 April 2012 the main rate of corporation tax will fall to 25%. The effective rate on profits between £300,000 and £1,500,000 will then be 26.25%. There will be further 1% reductions in the main rate in each of the following two years.
- These limits are shared equally among associated companies, that is, companies under common control, and are reduced proportionately for accounting periods of less than 12 months.
- Individuals have a personal allowance of £7,475 in 2011/12. The allowance is reduced by £1 for every £2 of taxable income above £100,000. The result is that a taxpayer who has income of £114,950 or more has a nil personal allowance.
- The personal allowance is projected to increase to £8,105 for 2012/13, with a corresponding reduction in the basic rate limit (currently £35,000) to £34,370.
- On income in excess of the personal allowance plus any other reliefs, tax is paid in 2011/12 as follows.

First £35,000

- 10% on dividends
- 10% on first £2,560 of savings income (only if taxable income is not more than £2,560)
- 20% on all other income

£35,001 to £150,000

- 32.5% on dividends
- 40% on all other income

Excess over £150,000

- 42.5% on dividends
- 50% on all other income

- Dividends come with a 10% tax credit. This means that where dividends fall within the basic rate band there is no more tax to pay. Higher rate taxpayers have to pay a further 22.5% of the dividend plus tax credit, equivalent to 25% of the dividend itself. Additional rate taxpayers pay a further 32.5% of the dividend plus tax credit, equivalent to 36.1% of the dividend itself.
- Company profits paid to a director as remuneration, or to a shareholder as dividends, are liable to the appropriate rates of income tax. This limits the amount of tax that might be saved through trading as a company. The tax benefit is greater where a significant amount of profits can be retained in the company. In those circumstances the comparison is between 20% corporation tax and 40% or 50% income tax.
 - It might be possible to extract these profits in such a way that little further tax is payable.
 - For example, dividends could be paid in years when the shareholder is not liable to higher or additional rate tax, or the company could be sold or liquidated, giving rise to a capital gain on which entrepreneurs' relief in effect reduces the tax payable to 10%.
 - A director's spouse or partner could own shares and receive dividends without necessarily being involved in the business. Such an arrangement might save tax if the spouse or partner has lower income.

For more details of how on income tax and corporation tax are calculated, see the separate topic 'The taxation of sole traders' and the separate topic 'Corporation tax'.

Example of tax comparison

The following example shows the potential tax saving that incorporation can achieve in 2011/12 on business profits of £60,000.

It assumes that the individual is entitled only to the basic personal income tax allowance, and that after incorporation the individual is the only shareholder and draws a salary of £7,225 (which maximises the saving) and all the rest of the profits in the form of dividends.

	Self-employed	Company
	£	£
Profits	60,000	60,000
Income liable to income tax on individual	Profits 60,000	Salary 7,225
Income tax on the above income	14,010	—
NIC	3,653	21*
Corporation tax: 20% on profits of £52,469 (£60,000 – £7,475 – £56)	—	10,494
Dividend (£60,000 – £7,475 – £56 – £10,494)	—	41,975
Higher rate tax on dividend (£41,975 × 10/9 – £35,000) @ 22.5%	—	2,619
Net income after tax and all NIC	42,337	46,801

*This figure is employer's NIC of £21 on the difference of £153 between the employer's and employee's NIC thresholds of £7,225 and £7,072. It is slightly more beneficial, in terms of net income, to pay this NIC than to limit

salary to £7,072 and pay a larger dividend. Paying a salary equal to the income tax personal allowance of £7,475, which would also incur a small amount of employee's NIC, also produces marginally less net income.

The company owner might be able to reduce the tax liability by limiting the payment of dividends liable to higher or additional rate income tax if the income is not immediately needed.

Expenses and benefits

The 'benefits' of a sole trader or partner, such as private use of a business car, are normally taxed by way of a 'private use' adjustment, increasing taxable profits. Most benefits received by directors fall within the 'benefits in kind legislation'.

- Individuals pay CGT on disposals of some business assets, such as land and buildings, goodwill, and shares.
 - The first £10,600 of annual gains is exempt.
 - The rest of the gains are taxed at a rate determined by adding the gains to the taxable income for the year. If the total is within the basic rate income tax limit (£35,000), the gains are taxed at 18%. Gains that fall above £35,000 are taxed at 28%.
 - Entrepreneurs' relief reduces the tax rate to 10% on the first £10 million of gains on the disposal of the whole or part of a business, or the disposal of assets after the business ends.
 - Entrepreneurs' relief is also available on disposals of shares in a personal trading company – a company in which the shareholder holds at least 5% of the ordinary shares and voting rights, and is a director or employee.
 - Availability of entrepreneurs' relief is subject to some conditions (see the separate topic 'Capital gains tax for business owners').
- Companies pay corporation tax on gains at normal corporation tax rates.
 - Companies do not get an annual exemption. Indexation of the original cost of an asset ensures that only gains in excess of inflation are taxed.
 - There are special rules for disposals of intangible assets, such as goodwill.
 - Companies are not liable to tax on disposals of trading subsidiaries, subject to several conditions.

For more details of the calculation of tax on capital gains for individuals and companies, see the separate topic 'Capital gains tax for business owners' and the separate topic 'Corporation tax'.

Two-tier capital gains tax

An individual who disposes of a business asset will pay CGT and then be free to use the remainder of the sale proceeds. When a company disposes of an asset and pays corporation tax on the gain, the company's owner might be liable to further tax when the proceeds are withdrawn. If the sale proceeds are not distributed as remuneration or as dividends, giving rise to income tax, it will eventually be necessary to sell or liquidate the company to obtain access to the money. This disposal could generate a second capital gain that is taxable on the shareholder.

It is difficult to compare the tax payable by an individual trader on the sale of business assets and the aggregate tax payable by a company and shareholder where an incorporated business sells assets and the shareholder withdraws the proceeds. This is because of the different effects of the indexation allowance and entrepreneurs' relief.

- Indexation will ensure that the company's gain is almost always lower than an individual's gain before entrepreneur's relief on the same disposal.
- Entrepreneurs' relief is only available in certain circumstances.

- The disadvantage of two-tier CGT is less where indexation is large compared to the gain.
- The problem of two-tier CGT can be avoided by owning business property outside the company, but this has disadvantages:
 - Entrepreneurs' relief will only be available on the property if its disposal is part of the owner's withdrawal from participation in the business, and relief will be restricted if the owner has received rent from the company.
 - The property would not qualify for 100% inheritance tax (IHT) business property relief.

Example 27.1 – CGT with entrepreneurs' relief

In a very simple case, a company makes a gain of £125,000 before indexation and pays corporation tax of £20,000 on an indexed gain of £100,000, leaving the company with £105,000.

On a liquidation of the company, the CGT payable by a shareholder entitled to entrepreneurs' relief (ignoring the annual exemption) is:

$$£105,000 \times 10\% = £10,500.$$

Therefore funds retained are:

$$£105,000 - £10,500 = \mathbf{£94,500}.$$

If the individual had owned and sold the asset personally, the tax payable, assuming the disposal qualified for entrepreneurs' relief, would have been:

$$£125,000 \times 10\% = £12,500.$$

Therefore funds retained are:

$$£125,000 - £12,500 = \mathbf{£112,500}.$$

Accumulating profits in a company

In contrast to the problem of two-tier CGT, entrepreneurs' relief makes it potentially possible to achieve tax of only 28% on trading profits by using a company.

- The company pays corporation tax at 20% on profits retained in the company.
- On a liquidation of the company, the individual pays CGT on the retained profits at 10% with entrepreneurs' relief.

For example, on £100,000 of retained profits the company pays corporation tax of £20,000. The individual then pays £8,000 CGT on the £80,000 of profits distributed in the course of a liquidation, an aggregate tax rate of 28%, compared with up to 50% if the individual had earned the profits as a sole trader.

- It is important that the accumulated profits retained are not so great that they endanger the company's trading status, which would deny the shareholder entrepreneurs' relief. This limits the scope of this tax planning strategy.
- The liquidation of the company would incur costs. At present an extra-statutory concession enables shareholders to pay CGT instead of income tax on distributions before the company's dissolution without need for a formal liquidation. However, draft legislation would impose a £4,000 limit on distributions that qualify for CGT. At the time of writing no date has been set for the change.

There is also tax avoidance legislation that HM Revenue & Customs (HMRC) could use to attack this strategy in extreme cases.

Relief for trading losses

Although the precise provisions vary, both individuals and companies can obtain relief for trading losses by:

- Setting them against any other income of the loss-making year.
- Setting them against any other income of the previous year.
- Carrying them forward against future trading profits of the same business.

Starting trading

Individuals can set losses in the first four tax years of a new trade against total income of the three tax years before the year in which the loss arose.

There is no equivalent corporation tax relief.

Ending trading

When companies cease trading, they can set any losses of the final 12 months of trading against trading income of the three previous years.

Sole traders and partners can claim a similar relief on the cessation of trading, including a cessation caused by incorporation as a company.

In some circumstances after incorporation, any unrelieved trading losses of a sole trader or partner may be carried forward against that person's future income (remuneration and dividends) from the company.

Employee participation

Share incentive plans and enterprise management incentives are fairly easy to set up and offer generous tax benefits for employees who hold shares or share options in their employing company. Although major shareholders cannot themselves participate in these schemes, they benefit indirectly through the greater motivation that employees have if they can participate in the company's profits. While sole traders and partnerships can enable employees to share in profits to some extent, any profit share paid to employees is fully taxable as remuneration.

Close companies

Most small companies that are set up as an alternative to trading as a sole trader or partnership are classed as 'close' companies.

- A close company is a UK resident company in which five or fewer participators together control the company. A company is also close if it is controlled by any number of participators who are directors. The term participator includes anyone with a financial interest in the company, such as shareholders and debenture holders.
- The main tax disadvantage of a close company is that loans to participators (generally shareholders) result in the company having to pay tax of 25% on the amount of the loan. Such loans have to be declared in the company's corporation tax self-assessment. The tax is payable nine months after the year end.
 - This tax is repaid to the company nine months after the end of the accounting period in which the loan is repaid.
 - Short-term loans that are repaid before the tax on them becomes due do not give rise to tax.

A close investment company is broadly a close company that is not a trading company or member of a trading group and also does not invest in property on a commercial basis. Such companies are charged at the main corporation tax rate of 26% on all their profits. The purpose of this rule is to discourage individuals from holding investments in a company to benefit from lower corporation tax rates. However, the disincentive has been eroded because of falls in the main rate of corporation tax and the introduction of the 50% additional rate of income tax.

Starting out as a sole trader or partnership

It is essential to register as self-employed with HMRC as soon as possible after the business starts.

- A person will be liable to a penalty if they do not notify their liability for Class 2 NIC by 31 January after the end of the tax year in which they become liable. That penalty may be up to 100% of the NIC unpaid as a result of the failure to register.
- Similar penalties may be charged in relation to income tax paid late as a result of failing to register by 5 October following the tax year in which self-employment started.

The registration procedure covers income tax and NIC (see the separate topic 'The taxation of sole traders').

- It is possible to register by telephoning the special HMRC helpline for the newly self-employed: 0845 915 4515 between 8am and 8pm, Monday to Friday and 8am to 4pm, Saturday and Sunday.
- Alternatively one can complete the form CWF1 at the back of the HMRC leaflet SE1, *Thinking of working for yourself?*. The leaflet also includes a form for registering to pay Class 2 NIC – the basic flat rate contributions – by direct debit.
- The registration form can be taken to any HMRC office or sent to:

National Insurance Contributions Office
Self-Employment Services
Application Processing Centre
Longbenton
Newcastle upon Tyne
NE98 1ZZ

HMRC will issue a self-assessment tax return in the April following the start of the business and every April thereafter. For information on self-assessment, see Topic 2, the separate topic 'Self-assessment for individuals'.

Choosing an accounting date

A sole trader can choose any accounting date, but an individual pays income tax on the profits of a tax year. Where the accounting period is the same as the tax year, or ends on 31 March, the profits of the tax year are simply the taxable profits of the accounting period.

Where the accounts run to a different date, the profits of the tax year are normally the profits of the 12-month accounting period ending in that tax year. However, there are special rules at the beginning and end of the life of a business.

There are some disadvantages of an accounting date ending late in a tax year, for example, 31 March.

- There may be only seven months from the end of the accounting period up to the date the tax return has to be sent to HMRC (ten months for internet filing).
- In contrast, a business with a 30 April year end will have at least 19 months to complete tax returns.

- Similarly, tax is payable sooner after the profits have been earned, giving a cashflow disadvantage if profits are rising.
- It is more difficult to decide whether to request a reduction in payments on account before the payments are due, because the amount of profits will not be known in time.
- The annual limit on contributions to registered pension schemes is 100% of earnings of the year (or £3,600 if greater) up to a maximum of £50,000. Unused annual allowance can be carried forward for up to three years. Anyone with earnings below the annual allowance who wants to maximise their pension contributions needs to know the amount of earnings before the end of the tax year.
- The opportunity to claim child tax credit and working tax credit may be missed. Entitlement to these credits is based on income of the tax year, but claims cannot be backdated by more than three months. A taxpayer with a late accounting date may not realise that a claim is worthwhile until late in the tax year. It is possible to make annual claims regardless of income, just to protect the right to a tax credit award if income turns out to be low enough, but this obviously involves extra work.

On the other hand, choosing 31 March as an accounting date has the benefit of simplicity and may avoid a large assessment when the business ceases, resulting from the special rules for the final year of a business (see Topic 23, the separate topic 'The taxation of sole traders').

Partnerships

Individuals thinking of trading as a partnership should first of all consider whether they can form a lasting working relationship with one another and whether they are happy to give up part of the freedom of being your own boss.

It is not essential to have a written partnership agreement, but it is preferable to formalise the relationship in writing to avoid future disputes, which sadly are all too common with partnerships.

A written agreement is also useful in cases where HMRC disputes that a partnership exists. Most commonly this occurs with a husband and wife partnership.

A partnership is not a legal entity in England and Wales, unlike a company. It cannot exist separately from its members.

Every partner is jointly and severally liable for all debts and obligations of the partnership while he or she is a partner. However, tax on partnership profits is not a joint liability of the partnership.

Instead, each partner is taxed individually on his or her share of profits and is liable only for the tax and national insurance on that share. Individual partners are treated in effect as if they are sole traders.

- They must register with HMRC if they join a partnership and pay their own Class 2 NICs.
- They must declare their share of the partnership profits on their tax returns and calculate and pay their own tax and Class 4 NICs.
- The partnership must complete partnership returns showing partnership income and expenditure, and profit allocations.

Setting up a company

A company is a separate legal entity that bestows a great deal of protection on its shareholders and directors, and so there is a great deal more formality to setting one up compared to starting an unincorporated business.

Company names

Before preparing or submitting documents of incorporation (see below), a check should be made against the Index of Company Names kept by the Registrar of Companies. This service is available on the Companies House website at www.companies-house.gov.uk.

- A name is not acceptable if it is the same as, or similar to, one already on the index.
- Some names require special approval.

Documents of incorporation

A company needs to file certain documents at Companies House.

- The memorandum of association is a statement that the subscribers wish to form a company, agree to become members and, where the company is to have a share capital, agree to take at least one share each. An objects clause is no longer required as every company has unrestricted objects. However, a company may choose to restrict its objects in its articles.
- Articles of association form the basis of the company's constitution. The Companies Act 2006 contains model articles that apply by default to all new companies unless the company registers its own.
- The application for registration states the company's name, whether liability is to be limited by shares or guarantee and whether the company is to be public or private.
- If the company is to have a share capital, it must register a statement of its share capital and initial shareholdings.
- A statement of the intended registered office of the company.
- A statement of the first directors and secretary (unless in the case of a private company there is no secretary), together with a statement that the requirements of the Companies Act 2006 have been complied with.

The documents needed for incorporation can be obtained from Companies House on 0870 333 3636 or through the Companies House website (www.companies-house.gov.uk).

Certificate of incorporation

When the Registrar has accepted the documents and company name, a certificate of incorporation is issued to bring the company into existence.

Company formation specialists

Ready-made and tailor-made companies can be bought from company formation specialists.

This is useful where a company is needed instantly.

They also often offer a free name check.

Start-up costs

Apart from any professional fees, a registration fee of £40 is payable, or £100 for same-day incorporation. If incorporation is carried out electronically, the fee is £14, or £30 for same-day incorporation. Special software is needed.

A third option is to use the online web incorporation service on www.businesslink.gov.uk. This allows a company limited by shares that adopts model articles in their entirety to be incorporated online without special software. The fee is £18. There is currently no same-day service.

The cost of a company from a formation agent starts at around £50, including the £14 registration fee, for a basic package.

Other costs may arise from the need to maintain:

- Minute books for recording meetings of directors and shareholders.
- A book of share certificates.
- Registers of members and share transfers.
- A register of the directors and secretary.
- Registers of debentures and other charges, if any.
- Books of account or appropriate computer software to record details of payments and receipts, debtors and creditors, and other assets and liabilities.
- A method of displaying the company name at the registered office and at all places of business.
- Printed letterheads, stationery, and other business documents, which must by law show the company's registered name. Most business documents must also show its registered office address, place of incorporation and registered number.

The first five items are often combined into one register, which a company formation agent can supply with the company package for an additional fee. It is not necessary to have a company seal and small companies do not normally need one. Accounting records and business stationery are necessary for any well-run business, whether or not incorporated.

Annual costs

In addition to start-up costs, companies incur annual costs.

- A limited company is obliged to file annual accounts with the Registrar of Companies. There are strict penalties if a private company fails to file accounts on time.
 - The filing date is nine months after the year end, or 21 months after incorporation for the first period.
 - Penalties start at £150 for a delay of up to one month. Accounts one to three months late attract a penalty of £375, with £750 for a delay of three to six months and £1,500 for a delay of more than six months.
 - The penalties are doubled if accounts are filed late a second time in succession.
- Small companies with turnover of £6.5 million or less and a balance sheet total of not more than £3.26 million do not need an audit. Accounts still have to be prepared in the form required by the Companies Act and accounting regulations, which means professional fees are likely to be higher than for a sole trader.
- An annual return must be filed with the Registrar of Companies, for which the filing fee is £40 if filed on paper or £14 if filed online. No special software is needed for online filing.
- Companies House sends annual returns automatically to all 'live' companies, other than those that file online, and these days most of the information is pre-entered and needs only to be checked.
- Companies that file annual returns online receive a reminder letter. The online filing process consists of updating the information held at Companies House if necessary and payment of the filing fee.

Value added tax

It is important to understand the VAT rules in the very early stages of the development of the business, whether or not it is incorporated.

HMRC leaflets, in particular, *Should I be Registered for VAT?* are recommended as introductory reading, or go to www.hmrc.gov.uk/vat/index.htm.

See also Topic 36, the separate topic 'General principles of value added tax'.

Registration

VAT is a tax on business turnover. Every business must register for VAT if its taxable supplies (i.e. business income on which VAT would have to be charged, including zero rated supplies) are more than the registration thresholds. These thresholds are normally increased in line with inflation each year. Since 1 April 2011, the registration limit has been £73,000.

Normally a business has to consider its taxable turnover over the previous 12 months, unless at any time taxable supplies are expected to be more than £73,000 within the following 30 days.

Registration is compulsory if:

- At the end of any month, the total value of taxable supplies made in the past 12 months or shorter period is more than £73,000. In that case, a form VAT1 must be completed and sent to HMRC within 30 days. The date of registration is the first day of the second month following the month in which the turnover limit was exceeded.

Example 27.2 – Registration

Limit exceeded in month ending	Notify on VAT1 by	Registration date
31 January	2 March	1 March
31 August	30 September	1 October

- At any time there are reasonable grounds for believing that taxable supplies of more than £73,000 will be made within the next 30 days. The date of registration is the date when it is known that the limit will be exceeded.

Every non-registered business must watch the threshold very closely. If a business should have been registered at an earlier date, HMRC will levy VAT on the business turnover from the date it should have been registered, less any allowable VAT incurred on purchases.

A penalty might be charged as well, unless the business has a reasonable excuse for its failure to register. Ignorance of the VAT rules is not an excuse.

Voluntary registration

If a business with a turnover of less than the registration limit wishes to register, then it can usually do so. An obvious advantage of 'voluntary registration' is that VAT on purchases can be recovered, whereas an unregistered business can only obtain relief if the cost of VAT can be deducted when calculating taxable profits.

- In general, when supplying goods and services to the public, non-registration will give a competitive edge and might increase profits, although this depends on the amount of VAT on purchases that cannot be reclaimed.
- Goods and services from non-registered suppliers might not be attractive to VAT-registered customers, because this will normally increase the cost to them. The reason is that the

non-registered trader's prices will have to take account of the VAT on purchases that cannot be reclaimed.

- Non-registration also indicates that the business is small and might reduce credibility.

Accounting for VAT

A business that is registered for VAT must charge VAT at the correct rate on its taxable business supplies and make VAT returns on time. It is important to get this right. There are penalties for under-declarations of VAT and interest charges where VAT is paid late.

There are several special schemes that benefit some businesses and it is worth finding out about them.

Taking on employees

If a new business takes on employees, it is important that the employer appreciates the need to comply with the PAYE regulations.

Complying with PAYE

Employers must deduct income tax and employee's NIC from salaries, and account for this to the Collector of Taxes, together with employer's NIC.

- Amounts must be paid 14 days after the end of each tax month, i.e. by the 19th of each month, with an extension to the 22nd if paying electronically. Late payment penalties may be charged where the full monthly payment is not made on time.
- Interest can be charged on amounts paid later than 19 April following the tax year (22 April for electronic payments).
- If the employer fails to deduct the full amount of PAYE tax and NIC that is due, the employer will still have to pay the full amount to HMRC and might not be able to recover it from the employee.
- If the monthly payments of tax and NIC average less than £1,500 a month, the employer can pay quarterly.
- Annual PAYE returns must be filed electronically by 19 May following the tax year, with automatic penalties for non-compliance.
- Returns of benefits in kind provided for employees and expenses paid to them (P11Ds and P9Ds) are due by 6 July and penalties can be levied for lateness and errors.
- Employer's NIC on benefits in kind is due by 19 July after the end of the tax year, with the return of benefits liable to NIC (form P11D(b)) due by 6 July.
- As HMRC conducts PAYE audits, any errors made by the employer are likely to be discovered eventually.
- PAYE deductions do not have to be made from payments to self-employed workers, but it is not possible to dress up an employment as self-employment. HMRC will check that any self-employed people are genuinely in business on their own account. If they are deemed to be employees, the employer will be liable for the tax and NIC that should have been deducted under PAYE. In cases of uncertainty it is possible to obtain guidance or a ruling from HMRC.

It is advisable to register as an employer with HMRC before taking on any employees. HMRC will then send all the necessary information to enable the employer to comply with the obligations.

Details of how to register and more information about PAYE is available at www.hmrc.gov.uk/payee/intro/index.htm.

Businesses that start during the period 22 June 2010 to 5 September 2013 may claim a deduction of up to £5,000 from their employer NIC payments if they meet the conditions of the regional employer NIC holiday for new businesses. Sole traders, partnerships and companies carrying on a trade, profession or vocation, property and investment businesses and trading charities can apply but their main place of business must be located in a qualifying region of the UK. Businesses in London, the South East and the East of England cannot qualify. More details are available at www.hmrc.gov.uk/payee/intro/nics-holiday/index.htm.

Spouse or partner as employee

Many self-employed business people pay their spouse or partner a salary for help in running the business, if the individual is not separately employed or self-employed.

- The salary must not be excessive for the work done and must actually be paid.
- Unless the spouse or partner has other income, a salary up to £7,475 would be covered by their personal allowance and therefore save tax. However, if the salary is over £7,072, NIC will arise.
 - A salary between the NIC lower earnings limit of £5,304 and the earnings threshold of £7,072 for employer's NIC will not require any NIC payments, but will give entitlement to benefits including the basic state pension and S2P.
 - Salary between £5,304 and £14,400 a year will accrue benefits under the State Second Pension (S2P) as if the salary were £14,400.
- Where spouses or partners are heavily involved in the business, it might be better to bring them in as business partners so that they can share in the profits without the need to pay tax and NICs under PAYE, although they will of course have to pay tax and Class 4 NIC on their profit share and will not accrue S2P benefits.

Setting up an accounting system and debt control

Both incorporated and unincorporated businesses need good records so that accurate accounts can be prepared, not only for tax purposes, but also because the bank will want to see them if the business needs credit facilities, and generally so that the owner or director can see how well the business is doing and identify any areas that could be improved.

Accounting records

It is vital that a business sets up an accounting system that is suitable for its needs. It does not matter whether physical books are used or specialist accounting software, as long as all transactions are recorded accurately.

- From a tax point of view, it is a statutory requirement to keep adequate business records. Penalties may be levied for a failure to do so.
- The books must be maintained regularly to provide accurate details of the trading performance.
- If records are kept on a computer, it is important to back up data regularly.
- Whatever accounting system is used, original invoices and receipts should also be retained as evidence. Where receipts are not available, for example, for small items of cash expenditure, details should be recorded as soon as possible after the expense.

- A business registered for VAT must keep specified records of the VAT output tax it has charged and the input tax it has claimed, so that it can show that its VAT returns are correct. Particular businesses may have to keep additional records.
- A business that takes on employees has to keep records of all payments made to them and of tax and NIC deductions made.

Debt control

Cashflow

Cashflow is one of the biggest problems encountered by small businesses, in common with many large concerns. The problem is particularly significant in the present economic environment. If a small business allows its customers unlimited credit, it will soon collapse through lack of cash or because its debtors have become bankrupt. It is essential, therefore, that a new business establishes a system of debt control.

- A debtors' ledger is essential for debt control.
- Even more important is to establish the creditworthiness of potential customers. This may be done either by contacting a credit agency or by asking your bank to carry out investigations. Where possible, take up credit references.

Factoring

Businesses can consider 'factoring' to give a cashflow benefit.

- Factoring essentially means that a finance house or bank buys the outstanding debts of a business and collects them for itself.
- The factor will deduct a percentage of the total debt as a fee and the business is relieved of both the risk and effort associated with debt collection.

Other issues

Government assistance

The Department for Business, Innovation and Skills (BIS) runs several small business advisory offices and these, together with various trade associations, can offer valuable assistance with the various government schemes that exist to help small businesses and advice on business planning generally. The nature and scope of grants and financial assistance potentially available is now very wide and may differ according to location. It is strongly advisable to obtain specialist local advice before starting in business, and before arranging any borrowings or starting any business projects.

The Grants and Support Directory (GSD) lists potential sources of help with starting up or business development. The database contains details of over 2,400 grant and support schemes from central and local government as well as private organisations. Some of the schemes offer financial assistance, while some offer free or subsidised services ranging from advice through to practical involvement with projects. It can be accessed at www.businesslink.gov.uk/bdotg/action/gsd.

The Enterprise Finance Guarantee (EFG) scheme guarantees loans from banks and other financial institutions for enterprises that have viable business proposals but who have tried and failed to get a conventional loan because of a lack of security. The EFG scheme is open to businesses with an annual turnover of up to £25 million, seeking loans of £1,000 to £1 million, repayable over a period of up to ten years. Many, but not all, business activities are eligible. The scheme guarantees 75% of the loan. The scheme replaced the Small Firms Loan Guarantee Scheme in January 2009. It will guarantee up to £600 million of new bank lending between 1 April 2011 and 31 March 2012 and over £2 billion in total up to 31 March 2015. Several banks participate in the scheme and applications should be made to them.

Regulatory matters

There are many other areas about which a small business needs to be aware, especially if it has an office or other business premises. They include:

- The requirement to provide employees with access to pension arrangements, where a business has five or more employees.
- Special tax rules for businesses involved in the construction industry.
- Business rates, payable to local authorities on business premises.
- Customs duties and regulations, where a business imports or exports.
- Data protection registration, if a business keeps information about people.
- Health and safety.
- Fire safety precautions.
- Protecting the environment.
- Employee rights under employment law.
- The national minimum wage.
- Laws against racial and sexual discrimination.
- Age discrimination in employment matters, including the ending of the default retirement age.
- The legal requirement for public liability and employer liability insurance.
- Consumer protection and fair trading regulations.
- Providing services and access to disabled people.
- Licences, copyrights, patent rights, etc.
- The requirement to display the owner's name and address at business premises if the business trades under a business name.
- Planning laws.
- The Electronic Commerce Regulations 2002, which govern business websites.
- Other laws and regulations that might affect particular businesses, for example, restaurants or agriculture.

Tax planning key points

Starting a business is an exciting challenge, but quite apart from the basic commercial risk, there are many pitfalls for the unwary.

- It is important to identify the potential problems, as well as the benefits, as early as possible, preferably in the business plan stage.
- It is essential to seek professional advice on accountancy, tax and legal matters from the very start – preferably well before the start of trading.

- HMRC has published a useful guide called *Starting up in business*, available from tax offices or on the HMRC website at www.hmrc.gov.uk/startingup/. There is also booklet SE1, *Thinking of working for yourself?*, and a more comprehensive publication, *Working for yourself – The Guide*, which covers many aspects of running a business apart from tax, and contains a long list of sources of information.
- HMRC has business support teams offering educational support to business enterprises and employers on how to comply with their tax and NIC obligations. Further information is at www.hmrc.gov.uk/bst/index.htm. Further information for small businesses can be found at www.businesslink.gov.uk.

This guide is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking action on the basis of the contents of this publication. The guide represents our understanding of the law and HM Revenue & Customs practice as at September 2011, which are subject to change.