

A Ltd Co can limit tax but also limit freedom

The problem with incorporation is that a limited company can be restrictive and costly to run. This is the view of NASDA member Ajit Thakrar, who warns that the creation of a dental practice limited company can be an unwelcome straitjacket.

In a detailed article, he lists 12 drawbacks to incorporation which he recommends should be considered by any practice-owner before embarking on incorporation. The drawbacks impact on taxation issues, superannuation, transfer of PCT contracts, insurance, mortgages, costs and much more.

The main attraction of turning your dental practice into a limited company, Ajit writes, is to reduce the amount of tax paid. But this can take some time to achieve because in the short-term, there are significant costs associated with incorporating. For some dentists, the reduction in their tax liability makes company formation worthwhile. For others, it's a trap.

For instance, to reduce tax liability, you have to reduce visible earnings. This is achieved by drawing a small salary from the company and then paying yourself dividends, which are taxed at a lower rate. However, if you need a mortgage (or to re-mortgage) in the future, your bank might not be willing to accept that dividends are part of your income.

Some advisors are forgetting to warn dentists that they still have to pay corporation tax, even though their personal tax liability is reduced. They also forget to warn about costs, such as paying tax on the value of the goodwill that is reflected onto the company balance sheet, and they forget to warn about the special arrangements necessary if the dentist retains the freehold of the property.

Said Ajit: "Incorporation may defer income tax liability but the benefits of this will depend on what amounts are drawn out from the business and at what rate as well as other individual circumstances. It is important that professional advice from a NASDA accountant is sought before embarking on this route and you think through the pros and the cons."

The full article is reproduced overleaf:

The limitations of limited companies

Ajit Thakrar warns that incorporation is not straightforward

Since amendments to the Dentist Act in the Autumn of 2005 made it legal for dental practices to incorporate, there has been a lot of interest from dentists in the formation of limited companies. The main reason appears to be a fiscal, or tax-saving, advantage. The "market value" of the goodwill at the time of incorporation is introduced on the balance sheet of the limited company and this is matched by the creation of a director's loan account. The goodwill value in the loan account is shown as a credit while the exact same sum is shown as a debit on the company's books. The director's loan account can be drawn from subsequently, effectively tax-free. By drawing a small salary (usually just above the NI limit) and paying yourself dividends up to the basic rate band, personal tax can be minimised.

However, it is clear from the lively debate surrounding incorporation issues at NASDA meetings, that there are potential problems.

Personal Tax Considerations

Capital Gains: On incorporation, capital gains tax needs to be paid on the difference between the actual cost of the goodwill when acquired and its market value on incorporation. This will normally be calculated at 10% of the gain. It will be a personal tax liability.

Income Tax: The incorporation of the business will result in "cessation" for income tax purposes and this may trigger additional liabilities if the dentist's year-end is not 31st March or 5th April.

Both these liabilities will trigger a cash outflow and can be met from the director's loan account in the company that has been created on incorporation, although this will have the effect of reducing the amount that can be drawn out in the future.

Superannuation

One area which causes particular difficulty is the impact of superannuation which is paid and deducted on the NHS Schedules each month. The proponents of incorporation work on the model that a low salary (usually just above the NI limit) together with dividends up to the basic rate band will be drawn; any additional drawings would be taken from the director's loan account which has been inflated by the goodwill which has been valued at market value and recognised on the balance sheet.

Clarification is being sought from the NHS Pensions Agency on how superannuable income should be allocated when the practitioner operates through a limited company.

Allied to this, one must consider that personal pensions are based on earnings, so if contributions are restricted this in turn will effect the pension at retirement age. It may be possible for the limited company to contribute directly to a pension scheme but that is for another article to consider.

Goodwill Valuations

The NASDA goodwill survey shows that practice values remain relatively buoyant but it is difficult to know how long this will continue in the present current economic climate. The possible loss in value of goodwill in the future will need to be considered under Generally Accepted Accounting Principles (GAAP) and this may have an impact on what can be drawn out as "dividends" in the future. Also, HM Revenue & Customs may challenge the valuation and this may limit possible tax savings.

Transfer of PCT Contracts

On paper it may seem sensible to incorporate but this may be impossible if the PCT does not agree. It is essential that written confirmation of the PCT's agreement is received before taking any steps to incorporate.

A substantial number of local PCTs have either refused point blank for the contract to be transferred from the individual to a limited company or have agreed to provided that the contract is substantially reduced by value and/or the reduction of UDA per patient.

Mortgages

There are a number of banks and building societies that are reluctant to regard dividends as income for mortgage purposes. This may limit the choice of lenders that you may be able to approach in the future if a mortgage (or re mortgage) is required.

Extra Work In Compliance

A limited company is a legal entity and must comply with the requirements of the Companies Act on record keeping.

Dentists trading through limited companies must maintain good accounting records. These need to be kept up to date. There must be a disciplined approach to amounts withdrawn from the company, distinguishing between salary, dividend and withdrawals from directors loan account at all times. Care and attention is essential.

It is not unusual for HM Revenue & Customs to ask for copies of the minutes of company meetings to support dividends and they will at some time inspect payroll records. A lackadaisical approach with regard to any such matters will no doubt lead to problems of overdrawn loan accounts, statutory penalties etc.

Sale of Business

It is often forgotten that when the business is sold there can be 'double taxation'. The company owns the business and the purchaser may not want to buy the company. As a result the company will need to sell the business to the purchaser and this sale of the assets will trigger a corporation tax charge and any amount then drawn out by the individual will trigger a further tax charge on him.

Experience suggests that where the goodwill and the other assets acquired are relatively small, it is unlikely that the purchaser will buy a limited company in view of the extra work required with warranties etc involved in acquiring such a small entity.

This trend may change over the years but it is not unusual for warranties, indemnities etc to run over 30 to 40 pages. The purchaser may also require a retention to be kept. It is usual that a purchaser will only consider acquiring the shares of the company when the transaction is both straightforward and large.

P11d Problems

Dentists usually have their cars, subscriptions, etc paid by the business. For a limited company this may cause P11d problems as they will be assessed as benefits to the principal who may be a Director but is also an employee of the company, just like other members of staff. Cars are a particular problem as a company car will result in a taxable benefit and also Class 1A National Insurance may need to be paid.

Permanent Health Insurance

In the event of a Permanent Health Insurance claim, insurance companies require proof of earnings of at least 3 years and, if small amounts are being drawn out as salary where a dentist is trading through a limited company, this will cause a financial problem as the maximum claim that insurance companies will pay will be 70% of the dentist's salary.

This can cause severe hardship that may to an extent be overcome by an insurance policy although this will only give a lump sum and is probably not as effective as Permanent Health Insurance benefit which goes up to normal working age i.e. 65.

Associated Companies

In terms of limited companies, the small companies corporation tax rate is, at the present time, 21%. However, one should bear in mind that if the dentists have other companies, either in their own or their spouse's name, this can increase the corporation tax paid.

Freehold Properties

It is not usually recommended that freehold properties are brought into the limited company and this will mean that these assets are retained by the principal outside the confines of the limited company.

However, this will mean that a formal lease needs to be drawn up between the limited company operating the dental business and the owner of the freehold property. This will entail legal costs and possible stamp duty. Under the new entrepreneur's relief the payment of rent by the business will no longer be efficient for Capital Gains Tax purposes.

Costs

In addition to the points mentioned above, there will be the cost of the valuation, shareholders agreement, contracts of employment and additional accountancy fees for a business operating under a limited company structure.

There are no tax consequences from an individual trading as a sole trader or partnership and transferring his business to a limited company. However, there are severe tax consequences if the process is reversed i.e the business is disincorporated and reverts to operating as a sole trader or partnership. In other words, once established, a limited company structure is a 'straight jacket'.

A sole trader or a partnership is, in essence, simple as one is directly taxed on the profits of the practice (not drawings) and, although one cannot shelter the profits as is possible in a limited company there are various other opportunities available such as paying a lump sum for pensions, venture capital trusts, enterprise zone trusts, investments, etc which can be used to reduce or mitigate ones tax liability.

It is clear that many advisers are advocating limited companies in view of the potential income tax savings. But this ignores the fact the corporation tax needs to be paid on the profits of the business (albeit at a lower rate) and "dividends" paid are not a deductible expense in working out the profits for corporation tax.

Incorporation may defer ones income tax liability but the benefits of this will depend on what amounts are drawn out from the business and at what rate. It is important that professional advice is sought.

Note

The Chancellor's budget proposals, announced after completion of this article, may make incorporation a more attractive proposition for some dentists in the future. NASDA members will be able to advise dentists once it is clear whether the proposals are going to go onto the Statute.