

INCORPORATION – A GOLDEN OPPORTUNITY OR A MINEFIELD?

Since the Dentist Act of 1956, dentists have been prohibited from running their practices through the medium of a limited company, with the exception of the 28 companies already providing dentistry services. Relaxation of these restrictions has been anticipated for some years, but it does seem that from the end of July 2006 practice of dentistry through a limited company might at last become a reality, and may well be permitted by the time this article goes to print.

Incorporation is a complex topic and involves a number of tax issues as well as commercial and political considerations. In this article the basic points are explained, but it is imperative that dentists intending to take advantage of this new opportunity do receive full and impartial advice to ensure they reach an informed decision.

What does this Involve?

A company is a distinct legal entity. It will be owned by shareholders and managed by one or more directors. These can be the same individuals.

If a practice is being purchased from an unconnected vendor, it is the company, rather than the dentist himself or herself, who will acquire the goodwill, equipment etc. Where the dentist already owns the practice, either alone or in partnership, the business will be transferred to the limited company, or “incorporated”.

The incorporation process has a number of implications. One of the key consequences is that for tax purposes the assets are transferred to the company at market value even if no payment is actually made. Thus when a dentist incorporates his own practice a capital gain will usually arise, although payment of tax can be deferred until the company is eventually sold.

Incorporation also marks the end of the sole practice or partnership, so there may be income tax consequences, on which your accountant can advise.

Practitioners need to be aware that accounts will be on public record at Companies House.

Why Might Incorporation be Attractive?

The most publicised benefits of practising through a limited company are the tax savings!

Let us take as an example a sole practitioner who becomes the only director and shareholder of his new company. He can take income from the company in the form of a salary, or as dividends. Payment of a salary involves National Insurance (NI) contributions: employer’s contributions are 12.8% of the salary, and employees’ contributions are 11%. Since both of these costs are effectively borne by our dentist, this is an expensive option and would cost more in overall taxes than remaining as an unincorporated practitioner.

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However, profits can be taken from the company in the form of dividends, pro-rata with the number of shares held. There is no NI liability on dividends, and this becomes an attractive alternative.

The top rate of tax for an individual is 41% including NI. Conversely, companies with taxable profits of £300,000 or less only pay 19% tax. If the profits are retained within the company, to be invested in new equipment for example, there will be no additional tax to pay. But when those profits are distributed to the dentist, a further tax liability will arise.

So to maximise the tax advantages the strategy might be:

- Pay a salary of £5,035 per annum (for 2006/07) to the dentist. This exactly covers the Personal Allowance, so is tax free. No NI contributions are payable at this level, yet it protects the dentist's entitlement to the basic state pension.
- Additional income requirements are provided in the form of dividends drawn from the company, on which no NI is payable. Further tax will be due on the dividends to the extent they fall within the higher rate tax band.
- Retain some profits within the company for investment in equipment etc or to provide working capital. Provided the £300,000 profit threshold has not been exceeded, the company profits will only bear tax at 19%.

Just as a guideline, assuming all of the profits are paid out to a single dentist, tax and NI savings compared with an unincorporated practice might be:

- on profits of £50,000 – tax saving of around £4,000 pa
- on profits of £100,000 – tax saving of around £5,000 pa

The savings will be greater where profits are retained within the company rather than being paid out, or where some of the shares are held by a spouse in a lower tax bracket, although care needs to be exercised with this.

Note that if there are "associated companies" the £300,000 profit threshold is reduced. The definition of associated companies is widely drawn and it is essential to take advice on this.

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What Formalities are Involved?

Company formation is relatively straightforward and inexpensive, but the taxation issues of incorporating the dental business do need to be properly dealt with and in particular the valuation of goodwill and its tax treatment for capital gains purposes. A professional valuation would be recommended so as to defend any challenge by the Revenue.

There are ongoing additional costs:

- Limited company accounts are more complex.
- There will be additional tax forms and compliance to deal with.
- Companies House impose filing requirements and the accounts will be on public record.
- Payment of salary and dividends to the dentist requires careful monitoring and minuting.
- Expense payments and reimbursements are within an exacting tax regime.
- Company cars trigger fixed taxable benefits for the dentist which can prove expensive.

All this means higher costs!

The GDC website has some pages of "Frequently Asked Questions" – May 2006, which provide some further information on GDC requirements.

Myths and Realities

- *The incorporation process will create a tax free loan account within the company which can be drawn on.* – Depending on how the incorporation process is dealt with, you can usually create a loan account of around £35,000 completely free of tax. A much larger loan account to draw on tax free may be possible if some capital gains tax is paid following the incorporation.
- *Corporation tax relief can be claimed on goodwill.* – A tax deduction may be claimed on expenditure incurred after 1st April 2002. So this will be of value to "new" practices. Note that you cannot get around this rule by incorporating a longer established practice.
- *Tax savings can be increased by paying salaries and dividends to spouse or partner* – Possibly, but non-commercial arrangements can be challenged by the Inland Revenue.
- *Tax can be avoided with an offshore company.* – Rarely possible.

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Partnerships, Associates and Expense Sharing Principals

- Incorporation works as well for partnerships as for sole practitioners. However, where the taxable profits exceed £300,000 the rate of corporation tax is higher and incorporation may therefore be less attractive.
- There is no reason why associates too should not practise through a limited company, and the issues are more straightforward as there is no goodwill to consider. Care should be taken however under the new NHS contract if the associate is paid a fixed share of income and thus become more like an employee. Some penal tax rules (known as IR35) could then be invoked.
- A more complex structure may be required for expense sharing principals to ensure each dentist receives the correct amount of income. Each may of course have his or her own company.

What about the Practice Freehold?

It is not necessary to transfer the freehold property to the company. The owner can charge the company a commercial rent, and the property will still attract favourable CGT treatment when sold.

Or why not consider transferring the freehold to a Self Invested Personal Pension?

Pension provision

Under the new rules from April 2006 an individual can obtain tax relief on pension contributions up to a maximum of his or her earned income for the year, but not exceeding £215,000. Dividends do not qualify as earnings for this purpose. Thus dentists who wish to make more substantial provision would need to pay themselves higher salaries, which is counter-productive as this involves NI contributions, as described above.

At the time of writing, the position re NHS superannuation contributions is not known.

What Happens When the Business is Sold?

There is no problem provided the purchaser will buy the company. The vendor would be liable for capital gains tax on the disposal, but with full business asset taper relief of 75% provided the company has been owned for at least two years.

If the purchaser is willing to buy the practice, but not the whole company, the company will be liable for tax on the gain on the goodwill, and there is no taper relief for companies. The vendor will still be liable for capital gains tax on the shares as described above, when the company is liquidated. There is in fact double taxation.

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Bear in mind that when a person buys a dental practice he or she generally acquires the assets – goodwill, equipment etc. The liabilities remain with the vendor. However the purchaser of a company is taking on all the assets and liabilities, including not only the unpaid bills and “visible” liabilities, but contingencies such as PAYE irregularities and other hidden problems. The process of checks or “due diligence” will become more complex and expensive, as too will warranties and so on.

Who is Incorporation Good For?

Large practices or groups of practices run on a businesslike basis.

- Easier to attract loan finance.
- Possibility of external investors.
- Range of corporation incentive schemes available to staff.
- Lower tax regime for profits retained in the company for investment in equipment etc.
- Easier to sell or pass on shares in a company.

What About Incorporation for Smaller Dental Practices?

The tax savings do provide an incentive to incorporate, but consider:

- Additional layers of administration and costs.
- Not advisable for practitioners with poor record keeping, or who use the business account as a personal “piggy bank”.
- Not advisable for dentists who spend more than they earn.
- Changes in tax rules and Revenue attitudes make the advantages less certain.
- Once the practice is incorporated, it can be difficult to unravel.

Dental practitioners are uniquely placed to increase spendable income and potential goodwill values by improving the practice and its profitability. Investment in planning a strategy for the practice may yield better financial results and personal fulfilment than incorporation.

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Some Final Words ... of Warning!

Tax motivated incorporations are not popular with the Revenue. The trend for businesses of all size and type to incorporate over recent years has caused a loss of tax to the Government which it has taken steps to counteract through a number of measures. A recent announcement sums up their attitude: "The Government believes that all individuals and businesses must pay their fair share of NICs and tax irrespective of legal form. It will continue to review the tax and NICs systems to ensure that this is the case ...".

Dentists may find they have gone through the incorporation process only to find the rules change, the advantages disappear and they are left with only the disadvantages.

Revenue attack can come from unexpected angles. Recently they have been claiming that goodwill is not a free-standing asset but attaches to the premises. If they are successful this could mean that Stamp Duty Land Tax would be due. In addition the favourable Capital Gains Tax treatment on transfer of goodwill to the company would be denied, as too would be the tax relief on goodwill within the company.

In Conclusion

It is not within the scope of this article to examine all of the issues. Incorporation may be the best route forward for some practices, but not for others. Other options such as Limited Liability Partnerships may provide an alternative particularly for larger practices. But the importance of taking professional advice and not taking short cuts in the incorporation process cannot be overemphasised, even though the costs may be significant.

No decision or action should be taken on the basis of information provided without reference to specialist advice. Incorporation is a complex issue and it is not within the scope of this paper to cover all of the issues.

The views expressed are those of the writer.

Contact Linda Nandlal at Archer Hayes for more information or a discussion.