Practice guide

Lifecycle of a business: setting up

Speed read

There are multiple tax issues to be considered when establishing a business, from structuring to claiming tax reliefs and tax compliance. Choosing the right jurisdiction and structure early on can be advantageous from both a commercial and tax perspective. As the UK continues to offer generous tax incentives to newly established businesses, a well-advised entrepreneur will be able to maximise the use of reliefs, both personally and at the level of the business.

Helen Cox
Fladgate
Helen Cox is a partner in the private client team at Fladgate. Helen specialises in advising on corporate and personal taxation, both domestic and international. She acts for private individuals, family offices, entrepreneurs, trustees and corporate entities. Email: hcox@fladgate.com; tel: 020 3036 7418.

Gemma Grunewald
Fladgate
Gemma Grunewald is an associate in the corporate tax team at Fladgate. She advises on a wide range of corporate tax matters, including transactional banking, M&A and real estate work. Email: ggrunewald@fladgate.com; tel: 020 3036 7188.

In January 2019, *City A.M.* reported that more than 216,000 new businesses were registered in the greater London area last year, a 6.45% increase on 2017. Across the UK as a whole, the number of new companies registered rose by 5.7% to over 660,000 – a record high despite an unsettled political and economic landscape.

In the first of a series considering the lifecycle of a business, this practice guide examines the key tax considerations for entrepreneurs during the start-up phase of a business.

Choosing the right jurisdiction

In a climate of continued focus on tax avoidance and with sensitivities surrounding the use of overseas jurisdictions that offer low or zero-rate tax regimes, it is not surprising that clients are increasingly hesitant to use overseas entities in their business structures. However, there are still circumstances in which establishing a UK entity with an overseas holding company may be an appropriate way to structure a business. For example, if the founders intend to seek funding from outside of the UK, using an overseas holding company may be more attractive to overseas investors. Other commercial reasons for using an overseas entity include flexibility for international expansion, asset protection or the location of key directors in overseas jurisdictions.

For non-domiciled and non-deemed domiciled entrepreneurs, an overseas holding company can also offer a shelter from IHT. This will be an important consideration if the entrepreneur's shareholding does not qualify for business property relief (which offers relief from IHT). For start-ups immediately operating through overseas jurisdictions as well as the UK, establishing overseas subsidiaries at an early stage may also be appropriate.

When an overseas entity will be ultimately owned by UK resident individuals, careful consideration should be given to the risk of double taxation, withholding tax issues, tax residence and UK anti-avoidance rules (including the transfer of assets abroad rules and the attribution of gains rules).

Where all aspects of the business, including the founders, employees, assets and financing, are located and likely to remain in the UK, establishing an entity headquartered in the UK is likely to be the most practical and tax efficient solution.

Choosing the right type of entity

There are a range of entities available to individuals setting up a business in the UK, including a company limited by shares or guarantee, an ordinary partnership, a limited partnership or a limited liability partnership. The choice of entity will be driven by commercial reasons, as well as tax.

From a commercial perspective, a sole proprietorship or general partnership may be simple to administer, but it will leave the business owners vulnerable as business liabilities will ultimately be the responsibility of the owners. In contrast, limited companies and limited liability partnerships are considered separate legal entities, although they are subject to extensive filing and administrative requirements.

From a tax perspective, partnerships are transparent and the profits/losses of the partnership are taxed on the individual partners. As in a sole proprietorship, partners are taxed at their own personal tax rate with income reported on their personal tax returns. The partnership itself must also file a tax return on behalf of all of the partners showing the profits of the partnership. In contrast, shareholders in a company limited by shares are taxed on the profits they extract from the business by way of dividends or capital returns, with the profits of the company itself being subject to corporation tax (after any available deductions have been made).

A UK company limited by shares remains the most common choice of entity for UK entrepreneurs, and is therefore the focus for the remainder of this practice guide.

Tax reliefs for entrepreneurs

The UK offers a number of tax reliefs designed to encourage individuals to invest in start-up trading companies. The seed enterprise investment scheme (SEIS), enterprise investment scheme (EIS), venture capital trust scheme (VCT) and social investment tax relief (SITR) are highly attractive to investors and can help alleviate the problems that small companies face in raising finance.

However, these reliefs are not available to founding shareholders and can only be claimed by investors on future injections of capital into the business (subject to certain conditions being satisfied).

One relief which is available for founders on the incorporation of a business is incorporation relief. In the absence of incorporation relief, the transfer of the trade/assets of a business from a sole trader or general partnership to a new company would be taxable as a disposal of the trade/assets for CGT purposes. Where incorporation relief applies, the charge to CGT on the original disposal is postponed until such time as the person transferring the business disposes of his/her shares in the new company. Incorporation relief is available pursuant to TCGA 1992 s 162 where:

- the whole of the business is transferred to a company as a going concern;

- all of the assets (other than cash) are transferred; and
- the business is exchanged wholly or partly for shares.

Where each of the above conditions is met, incorporation relief is applied automatically. For individuals who have operated as a sole trader while getting their business off the ground, this relief is essential.

Where the conditions for incorporation relief are not satisfied, a claim for gift relief under TCGA 1992 s 165 may be possible. Gift relief also operates to defer a CGT liability arising on the disposal of business assets but, unlike incorporation relief, it works on an asset by asset basis and must be claimed. For example, if a partnership wishes to incorporate its business, but the individual partners intend to keep the property in the names of the individual partners, a claim for incorporation relief will not be possible as not all of the assets of the business will be transferred to the new company. Instead, gift relief could be claimed on the assets transferred. A claim for gift relief must be made jointly by the transferor and transferee within four years from the end of the tax year in which the disposal occurs.

Case study: Helen and Gemma

Helen and Gemma began working together on a new venture in 2018, designing and manufacturing skincare products. Helen is responsible for formulating the products themselves, whilst Gemma focuses on the administrative and manufacturing side of the business. The business has not yet generated any profit, and to date Helen and Gemma have split expenses equally. The two entrepreneurs are seeking advice on how to structure their business going forward. In particular, they wish to:

- limit their liability;
- allow Helen a greater share of any profits to reflect her technical expertise;
- benefit from any favourable tax reliefs in the running of the business; and
- allow for future expansion and investment should their business succeed.

The business is UK-focused and there is no current intention to expand overseas or seek overseas investment.

Key considerations:

- Helen and Gemma should incorporate a UK company and transfer all of the assets and trade of their business to this new company in exchange for shares. The transfer should be documented in a simple asset transfer agreement, including a ‘sweeper’ provision to ensure all assets transfer.
- The shareholdings should be split to reflect Helen’s expertise. Helen could hold a higher percentage of ordinary shares, or Helen and Gemma could consider separate classes of shares with different rights attached.
- Helen and Gemma should consider entering into a shareholders’ agreement to document their rights as shareholders.

Tax reliefs for the business

In a series of measures introduced over the past 20 years, successive UK governments have supported businesses by providing tax reliefs to encourage both innovation and investment. The reliefs highlighted below may be particularly beneficial for newly incorporated companies.

Pre-trading expenditure

Corporation tax relief is available in respect of certain expenditure incurred not more than seven years before the date on which the company starts to carry on the trade. CTA 2009 s 61 provides that if, in calculating the profits of the trade, no deduction would otherwise be allowed for the expenses but a deduction would be allowed for them if they were incurred on the date the company began trading, the expenses are treated as if they were incurred on that date, and are therefore an allowable deduction in calculating the taxable trading profits of the company.

Use of trading losses

There are a number of options available to a single limited company for the use of trading losses:

(a) set a loss against the total profits in the current accounting period;
(b) carry back a loss and set against the total profits in the preceding 12 months;
(c) carry forward a loss made before 1 April 2017 and set against the next available future trading profits from the same trade; and
(d) carry forward a loss made after 1 April 2017 and set against total profits of a later accounting period.

Although limb (d) above extends the use of carried-forward trading losses arising in periods post 1 April 2017, the use of these losses is restricted. Companies and groups are entitled to a £5m allowance against which carried forward losses can be set, after which the amount of profits that can be reduced by carried forward losses is restricted to 50% of the remaining profits. Although this restriction is unlikely to impact a company in its formative years, it should be considered when projecting future profits.

UK companies also benefit from loss relief in relation to losses arising from non-trading loan relationships, losses arising from property businesses (both UK and overseas) and capital losses.

Capital allowances

In the early days of business, a start-up is likely to incur expenditure on purchasing capital assets for use in the business (for example, machinery, motor vehicles and property). Where expenditure is of a capital nature, such costs are not deductible from trading profits. Instead, capital allowances can be claimed on qualifying plant and machinery. Capital allowances operate as a form of tax-approved depreciation with annual written-down allowances on eligible expenditure as follows:

- 18% on expenditure in the general rate pool;
- 6% on expenditure in the special rate pool (reduced from 8% with effect from 1 April 2019); and
- 100% on designated energy-saving plant and machinery and environmentally beneficial plant and machinery purchased new and unused where the expenditure is incurred before 1 April 2020.

Businesses can also avail themselves of the annual investment allowance (AIA), which from 1 January 2019 until 31 December 2020 has been raised to £1m. The AIA provides 100% relief on expenditure on qualifying plant and machinery. On 1 January 2021, the AIA will revert to £200,000.

If the company is acquiring a property, it should be aware that not all property expenditure attracts capital allowances. CAA 2001 ss 21–38 provide a comprehensive list of what constitutes qualifying plant and machinery for these purposes. Where real estate is purchased, the parties may agree an apportionment of the selling price between the building itself and the qualifying fixtures within it (commonly referred to as a s 198 election). This avoids the potentially contentious apportionment rules and can also offer tax advantages in favour of either the seller or the buyer in the form of balancing allowances or increased capital allowances claims, as appropriate.

Case study: HG Ltd

Following our earlier advice, Helen and Gemma established HG Limited in January 2019, a UK incorporated and tax resident company, with ordinary share capital of 100 shares of £1 each. Helen owns 60 shares and Gemma owns 40 shares.

Helen is continually undertaking work to improve and adapt HG Limited's products. HG Limited is currently loss making but, with an upward trajectory on sales, it envisages making substantial profits over the coming years.

With expansion on the horizon, HG Limited is looking to purchase a property to use as both office space and a storage facility for its stock.

Key considerations:

- Now established, HG Ltd should seek advice on its notification and filing requirements (see 'Compliance' below).
- HG Ltd may consider making a future claim for the unrelieved trading losses brought forward to be set against total profits of a future accounting period.
- To the extent that the property contains any fixed plant and machinery, HG Ltd should enter into a s 198 election with the seller.
- HG Ltd should consider whether the activities undertaken to improve and adapt its products will be 'qualifying activities' for R&D purposes. It may be helpful to seek clearance from HMRC if Helen and Gemma want certainty around the tax position.
- HG Ltd is still loss making and therefore the cost/timescale of registering a patent and the complexity of the patent box calculations may outweigh the benefit of electing into the regime at the current stage of the business. This should be reviewed as the business expands.

R&D for SMEs

The majority of start-ups will incur costs in developing or acquiring intellectual property (IP). A small or medium sized company (SME) incurring 'qualifying' research and development (R&D) expenditure will be able to claim a deduction equal to 130% of the costs incurred in calculating its taxable profits. This deduction is in addition to the usual 100% deduction, bringing the total relief available to 230% of any qualifying costs.

CTA 2010 s 1138 defines R&D as activities that fall to be treated as R&D in accordance with generally accepted accounting practice. Broadly, R&D takes place when a project seeks to achieve an advance in science or technology. Where there is uncertainty as to whether expenditure will qualify, a clearance procedure is available.

Start-ups will commonly be in a loss-making position before taking into account any R&D relief. To assist, CTA 2009 s 1054 enables SMEs to surrender part of that loss ('the surrenderable amount') to the government in return for a tax refund. The surrenderable amount is the lower of:

- the unrelieved trading loss (being the trading loss of the period, as increased by any additional R&D relief claimed, but as reduced by any actual and potential claims for relief for that loss in the current period and any other actual loss reliefs claims made in respect of that loss); and
- 230% of the qualifying R&D expenditure.

The amount of the credit is 14.5% of the surrenderable loss for the period. The credit is used to reduce the company's corporation tax liability for the period, or if there is not one, it is paid to the company.

As of April 2016, large companies are subject to a different scheme under which they can claim R&D expenditure credit (RDEC), although this is unlikely to apply in the context of a start-up.

Patent box

A company which holds any qualifying IP rights, or which holds an exclusive licence in respect of any qualifying IP rights, may also benefit from the UK patent box. For profits arising after 1 April 2013, a company may elect that any relevant IP profits related to a trade of the company are effectively chargeable to a lower rate of corporation tax, taxing the profits arising from specific categories of IP at a preferential rate of 10%.

To benefit from the regime, the claimant company must notify HMRC in writing. Such an election must be made within two years after the end of the accounting period in which the relevant profits and income arose. Once an election has been made, the relevant company will remain in the patent box regime until it decides to opt out.

Although the government introduced the patent box to incentivise companies to continue to carry out innovative activity within the UK, the regime only operates as a tax relief to reduce taxable profits. Therefore, it is of limited or no use to companies in loss-making years (unless such companies have a profitable patent stream where a patent box claim could reduce those streamed profits, thereby preserving tax losses).

(See the HG Ltd case study.)

Compliance

New companies must also comply with certain administrative and filing obligations. With an extensive penalty regime for failures, clients should be warned in a timely manner of relevant deadlines. In particular, a company must notify HMRC in writing within three months of the start of its first accounting period, and will be required to register for VAT where:

- the value of its taxable supplies in the previous 12 month period has exceeded £85,000; or
- there are reasonable grounds for believing that the value of its taxable supplies in the next 30 day period will exceed £85,000.

Although it is unlikely that many start-ups will be required to register for VAT in their early days, depending on the nature of the business and expenses incurred, founders may wish to voluntarily register their companies for VAT in order to benefit from input tax recovery at an early stage.

In the Business Lifecycle Report published in April 2018 (see bit.ly/2J8NTMa), the Office of Tax Simplification (OTS) suggested that the general administrative burden for small incorporated businesses could be reduced by introducing a seamless 'one-stop shop' registration and filing facilities. The OTS also flagged that a joint registration process using the gov.uk web incorporation service is in the process of being developed. Such a system might entice sole traders to incorporate their businesses sooner than they otherwise might have done.

Looking forward

Once a business is established with a suitable structure, the shareholders/founders can look forward to future investment opportunities and consider expansion. However, with a potentially profitable business, succession planning should be a key tax consideration for the founders. In our next guide in this series, we will look at practical considerations for shareholders in managing the personal tax position for both themselves and their families. ■

For related reading visit www.taxjournal.com

- ▶ A simple journey through the business lifecycle (Paul Morton, 24.5.18)
- ▶ Enterprise tax reliefs (Zoe Fatchen, 28.5.15)