



Guidance on incorporation: 2018

***By Johnny Minford, Chartered Accountant and
Russell Abrahams, a Solicitor***

Incorporation of a dental practice is a more complicated transaction than many might think, if the advisers are properly to optimise the benefits for their clients. There are also a number of longer-term consequences, both positive and negative. NASDAL specialists will always go beyond the short-term benefits and explain the full and complete consequences of incorporation. This is particularly relevant right now. Recent tax changes have caused many dentists to consider disincorporation, due to increased tax exposure. Disincorporation, in turn, brings its own complications.

There are of course still reasons to incorporate other than the simple reorganisation of affairs to reduce tax. Assuming incorporation still makes financial sense, the purpose of this guidance is to highlight and illustrate the tax consequences of incorporating under current rules.

Before 2015

The main attractions of incorporation for many before the tax changes following the autumn statement of 2014 was that, if drawn tax-efficiently, profits could end up in the hands of the individual at lower tax (and NIC) rates than via operation as an unincorporated practice. For example, the first £40,000 (approximately) of income could be received by the individual free of personal tax and NIC, with the company only suffering corporation tax on most, but not all of this sum. Income above that point generated higher rates of tax, but still at largely preferential rates compared to those paid by unincorporated businesses.

There was also the 'feel-good' "cashing in" of Goodwill, which essentially turned a sum of future profits which would have been taxable at income tax rates (generally 40-45%) into something apparently taxable only at capital tax rates (10%) after the annual exemption. After payment of CGT on the value of the goodwill, the balance could be withdrawn from the company with no further tax payable in the hands of the individual, although Corporation Tax on the profits at 20% (now 19%) was charged to the company.

NASDAL Guidance

To add to the favourable treatment, the company used to be able to claim, in some circumstances, a deduction through the Profit and Loss for the amortisation of goodwill over time, but this has also now been abolished.

Once the value of the Goodwill had been extracted from the company, then the dentist would have his/her remuneration from the company taxed at the same individual rates as pre-incorporation, although with certain tax structuring, there were elements of National Insurance, pension planning and other peripheral charges which could be beneficially treated or side-stepped.

Changes

There have been two major changes in the tax regime since 2015 which financially affect the concept of Incorporation.

The first change was the removal of the availability of the 10% CGT rate (Entrepreneur's Relief), so that between 'normal' CGT at 20%, Income Tax and Corporation Tax at 20% (now 19%), the dentist paying 40% tax on profits as an individual was little or no better off, and incorporation in a basic form became without purpose. It is still possible to structure a package tax-efficiently, subject to the income levels, but the margins and circumstances are slimmer.

The second change was the treatment of dividends paid to shareholders of a company. This effectively pushes additional tax onto the individual shareholder, so that the use of the lower corporation tax rate is diluted. Under the Basic Rate threshold, the shareholder is taxed at 7.5% on dividends; over this at 32.5%. For earners of over £150k pa, the rate is 38.1%. Whilst this still appears preferable to normal income tax, bear in mind that this is taken after Corporation Tax (currently 19%). The effective tax rates post CT and post IT, taking into account the various reliefs, are now 25.1%, 45.3% and 49.9%.

That top rate of tax on dividends now means that those with incomes above a certain level can be actually paying slightly more tax via a limited company than they would have as an unincorporated practice.

Current Position

The above was however always a simplistic approach, there were always other consequences to incorporation, some adverse, some potentially positive. The mere change in tax rates still leaves some of these positive aspects available, but in much narrower circumstances.

This guidance does not purport to give a full synopsis of all those circumstances, as every dentist's situation is different. Proper tax planning depends on individual situations, a long term view and personal factors, not just simplistic headline tax rates.

Transfers at Incorporation

It is important to recognise, first and foremost, that the Limited Company ("NewCo") is a separate legal entity and personality from the Sole Practitioner or Partnership ("Dentist"). It is not helpful to visualise NewCo simply as a wrapper around the Dentist's profits, with everything else carrying on just as it was. The incorporation of a practice is better envisaged as an arms' length sale from Dentist to a quite separate party, NewCo.

For an incorporation to take place, the physical and financial assets and liabilities of the practice must be properly transferred to NewCo.

NASDAL Guidance

It follows that, as a general principle, no business assets which are being used by the practice in its day to day operations should be left in the clinician's personal ownership ie outside NewCo.

Assets which should be transferred may include, for example, dental chairs, equipment, such as cabinetry, more portable equipment, such as OPG, autoclaves, and stock. In general, those assets are transferred at tax written down value, so there is no capital allowance claim benefit.

Particular care needs to be taken for those assets held on finance, where the finance agreement is in the name of the Dentist. Such assets cannot be transferred to NewCo without the agreement of the finance company, and very often the finance company will not easily give this agreement, preferring for the liability to remain personally with Dentist. In this case, a separate agreement must be set up between Dentist and NewCo, essentially to rent the asset to NewCo. It is not enough for NewCo merely to take over the standing order. Steps need to be taken to pass ownership.

Not every asset and liability needs or should be transferred to NewCo. For example, the Dentist would not normally transfer cars to NewCo, to avoid penal benefits-in-kind taxation. The tax rules relating to private use of business vehicles differ significantly upon incorporation. This itself is an area for tax planning.

Also, the Dentist's practice or property loans in his/her personal name may be left out of the transaction, subject to the bank's agreement and the security terms.

Interest payable on practice loans is generally tax deductible against the profits arising from that business. If the business profits are transferred to NewCo, then care needs to be taken to ensure that the interest on the related loan continues to be tax deductible. Interest on property loans where the property is not transferred to NewCo needs special treatment.

As with equipment finance, it is not simply enough to change the standing order from Dentist's account to NewCo's account.

The employees' employment must be transferred to NewCo. This entails a separate PAYE Scheme to be set up, and the employees transferred to it. The transfer of undertakings regulations (TUPE) need to be followed, which gives the employees the protection of continuous employment. However, P45s must be issued and a new Scheme started.

On a related note, the self-employed personnel, that is associates and hygienists, must also be transferred to NewCo.

Superannuation will follow the provider, and if the Contract has been properly transferred into the name of NewCo, the superannuation deductions should follow.

However, under the current guidelines (17/18):

- The Principal may only rank for superannuation to the extent of his/her aggregate dividends and salary, pro-rated, based on the split of Gross fees between NHS and non-NHS.
- Incorporated associates will be excluded from involvement in superannuation contributions. This is because being superannuated is a personal 'relationship' and the insertion of a company between the provider and the performer breaks that 'personal' link and turns it into a subcontract arrangement across which the entitlement to superannuation does not flow.

The interrelationship between incorporation and superannuation is in itself a complex area, and is not addressed in this article.

One major asset which usually remains with Dentist on incorporation is the practice premises.

If the property is freehold, Dentist would normally retain the freehold, then enter into a Lease between Dentist as the landlord and NewCo as the tenant. However, this could create CGT problems, and restriction of Entrepreneur's Relief on eventual sale, which requires careful thought. There is also a difference in IHT Business Property Relief in owning the property outside of the company, if IHT is an issue. Not paying SDLT on transfer into the company would be an incentive to leave the property out. The interaction of various taxes need weighing up to consider the best option.

If the property is leasehold, it would be normal for the Lease to be assigned by Dentist to NewCo. Dentist would be expected by the landlord to guarantee the obligations of NewCo under the Lease.

The largest asset of the Dentist may well be his/her Goodwill. There are two aspects of this:

- Its valuation
- Its transfer

The valuation of Goodwill is a sensitive issue, leading as it does to a Capital Gains Tax charge, which will, even under current rules, be at a lesser rate than normal income tax rates (we do not comment here on the timing/saving/deferral arguments in this respect).

Goodwill needs to be valued at arms' length market value, and this must be done by a competent specialist dental valuer. Dental practices, whether private or NHS, are unlike other businesses, and there are particular approaches which apply.

Transfer of Goodwill to the Company

The Goodwill must be actively transferred to NewCo, which will be one of the matters addressed in the Sale Agreement.

For an NHS Contract made between Dentist and NHS England, this must be replaced by a Contract between NewCo and NHS England. This requires NHS England to re-issue the NHS Contract to NewCo.

NHS England may, where the UDA value exceeds the average, around £25.50, take the opportunity to renegotiate the UDA rate. They may even refuse agreement altogether on some perceived basis, but guidance suggests that straightforward incorporation should be agreed by NHS England.

It is not sufficient simply to assign the benefit of the Contract.

The main reason for this is that clause 12 of the GDS Contract expressly prohibits assignment of the GDS Contract. It is therefore crucial to press NHS England to re-issue the NHS Contract in the name of NewCo.

NASDAL Guidance

There are circumstances where NHS England will validly refuse to reissue the NHS Contract in the name of NewCo or will not make a decision within any reasonable time-frame.

In these circumstances, another option is to sub-contract the NHS Contract to NewCo, with the consent of NHS England. However, this can give rise to superannuation and contractual difficulties. Obviously, very careful legal guidance is required in these circumstances.

This structure is known as a flawed incorporation and certain accountants advise their clients not to purchase a practice structured in this way. The reality is that many hundreds of practices are held in this way, including the vast majority of NHS practices owned by My Dentist and BUPA. Abrahams Dresden has bought and sold a very significant number of practices whose structure is flawed in this way.

There are two broad taxation approaches to transferring Goodwill into the company from a Capital Gains perspective. If the value of the Goodwill has increased since original purchase, there will be a Capital Gains exposure on the uplift, and it is this which has to be addressed.

The first approach is to apply to defer the Capital Gains Tax using one of two reliefs available, by retaining the original cost on the initial purchase by the dentist which may even be nil if the practice was initially a squat. The net result is that the company acquires the Goodwill for tax purposes at the same Base Cost as the original purchase cost, and no tax is payable at this point. If the company sells the goodwill in the future, Corporation Tax is paid on the whole difference between the original purchase price and sales proceeds.

There are some accounting consequences to the transfer using this method, avoiding tax now, as the Goodwill still has to be presented at its market value on the Balance Sheet, not the original tax Base Cost, and this may have consequences to the ability to withdraw funds from the company in a tax-efficient way.

The other approach is to simply sell the Goodwill at its current market value to the company without claiming deferral of the Capital Gains Tax, which remains payable at 20%, on the uplift between the original purchase price and the current market value. For example, if the practice has originally purchased its goodwill for £200,000, and its market value at the point of incorporation was now £300,000, then (in very round terms and ignoring annual exemptions) there would be a capital gain of £100,000, and Capital Gains Tax arising of £20,000.

However, this creates a debt from the company to the dentist just as in the 'old' days -- which can be drawn out over time..... the Director's Loan Account. The difference now is that CGT is arising at 20% rather than at the Entrepreneur's Relief rate of 10% as before.

This utilises an annual exemption for capital gains, and if the dentist is in a position to organise their circumstances to restrict their earnings within the Basic Rate band, perhaps using a spouse's band in addition, this can be a viable approach. There is still a benefit since most dentists would be otherwise paying tax at 40% on the amount they draw from the company. Gains falling in the basic rate band are only taxed at 10%, so that it is possible for a gain of say £80,000, split equally between husband and wife, to generate less than £6,000 in tax, in the right circumstances.

In general terms, it is worth mentioning that some consider 20% a low CGT rate, compared to historical highs for gains that do not attract reliefs.

The Money Box Company

NASDAL Guidance

In the situation where surplus profits are created by the practice, which are not required by the dentist, there can remain benefits to incorporation. If the dentist generates profits of £150,000 but needs only £100,000 drawings, then the surplus £50,000 can be left in the company at corporation tax rate, 20%, rather than being taxed at the higher personal rates. Over the years, all these surpluses will add up, potentially into a substantial sum which has accumulated subject to 20% tax rather than 40% or 45%. Over a number of years, the amounts accumulated could be substantially higher due to the compounding effect of the lower tax. On sale or retirement, these funds would of course need to be extracted from the company and subjected to personal income or capital gains tax rates at that time.

There are approaches to this which, in certain situations, can be taken to minimise the impact, and may still leave the dentist better off for having incorporated. This requires specialist advice at the point of unwinding, which goes beyond the scope of this article.

Future Retirement

There is a further consideration on the final sale of the practice, , and this relates to whether or not the eventual 'retirement' sale is an asset sale or a share sale. In the first, the company will pay Corporation Tax (currently 19%) on the uplift from the acquisition cost to the company. This depends on whether the gain was deferred or not at the point of incorporation. However the proceeds then belong to the company, and the dentist shareholder faces further tax to extract the cash from the company.

This can be done by putting the company into liquidation and electing to have the proceeds treated as a capital gain, claiming Entrepreneurs' Relief at 10%. Alternatively there are approaches utilising Pensions, or indeed plans to extract the funds over a number of years if the dentists' income tax rates are favourable. Detailed tax advice must be taken at the time to minimise tax.

If the shares of the company are sold, then a further Capital Gain arises in the hands of the dentist/shareholder on which Entrepreneurs' Relief at 10% can be claimed. The Base Cost may be the cost of the shares (£1 each) or the original Base Cost of the incorporated practice, depending again on the incorporation method used. Detailed tax advice must be taken at the time to minimise tax.

As alluded to earlier in this article, there is often no material overall benefit to incorporation, if there are no other facets of the transaction. The tax rates applied, between Capital Gains and Corporation/Income Tax, leave the dentist overall little better off than if he/she had remained self employed. Indeed, looking at the direction of tax travel, in some instances the dentist shareholder may actually be worse off than if they were self employed. There will be winners and losers on incorporation under the new rules. Calculations need to be performed.

However it is the isolation and usage of those other facets in certain circumstances which can still create a commercial benefit to the dentist – moving income from an area/person/time of Higher Rates to an area/person/time of Lower Rates.

Summary

Incorporation provides the ability to control and manipulate income levels, to optimise tax efficiency that is often not available to an unincorporated practice, which are simply taxed on the face of profits arising for the year. All situations are different. Generally speaking though, the tax benefits of incorporation have been reduced.

NASDAL Guidance

Incorporation of a dental practice should be done fully and completely, and it requires the use of a specialist Solicitor to draw up the Sale Agreement, the Lease, the transfer of the NHS Contract and the personnel, and assist with any switches in security relating to finance changes. A specialist accountant also has to contribute to the Sale Agreement, and on the mechanism to draw up and quantify the final valuations of the practice at Completion.

The Dentist's advisers should ideally work as a team to ensure that the Dentist reaps all the benefits available from incorporation, and avoids the pitfalls, which may take a few years to become evident.

Most importantly, the dentists' professional advisers must ensure that the decision to incorporate is made with a full and complete knowledge of the facts and consequences, both short and long term.

The above guidance was drawn up by Johnny Minford of Minford Chartered Accountants and Russell Abrahams of Abrahams Dresden LLP. Johnny can be contacted on 01904 414471 Email: Johnny@minford.eu and Russell on Russell.Abrahams@Ad-solicitors.co.uk 020 7251 3663. To find out more about NASDAL, www.nasdal.org.uk