Your money and your business

As the owner-manager of a small or medium enterprise, your own financial affairs are likely to be closely entwined with the way you run your business.

You should think about how the business will affect your own finances from the moment you start up and continue to keep this in mind throughout its lifecycle.

This briefing outlines how you can manage both the investment you put into the company and the income, profits and other benefits you and your family get from it. It covers:

- Choosing the business structure which is most financially advantageous to you.
- Financing the business in a tax-effective way.
- Extracting profits and making investments.
- Exits and inheritance.

1 Structuring your business

The legal form of your business will affect your financial position.

1.1 Unincorporated businesses — sole traders, partnerships and limited liability partnerships — give you the flexibility to withdraw funds for personal use at any time.

- Profits are mainly taxed as income in unincorporated businesses.
  They are good if you do not want to retain profits in the business, and just want an income and some kind of pension.
- National Insurance contributions (NICs) are generally lower than if you were an employee of a limited company.
- Sole traders and members of a partnership have unlimited liability for business debts.
- As the name suggests, a limited liability partnership (LLP) lets you limit your liability. While strictly a corporate vehicle with legal requirements similar to those of a limited company, an LLP is generally taxed as an unincorporated business.
- Partnerships are flexible arrangements which make it easy to share high levels of profits between family members.
  You do not have to justify a spouse or civil partner's level of remuneration to the HM Revenue & Customs (HMRC) as you would if they were employed by a limited company.

1.2 If you want to retain profits and build capital value in the business, forming a **limited company** (incorporation) is the right option.

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- Corporation tax payable on a company's profits will generally be lower than comparable income tax liabilities.
- You can pay yourself a combination of salary and dividends — which are free of NICs (see **3.2**).
- All dividend payments (except those to companies) are now subject to corporation tax of at least 21 per cent. But shareholding employees in companies with profits of up to £300,000 will still pay less tax and NI on dividends than they would on the same amount paid to them as wages.
- The settlements legislation aims to prevent an individual from gaining a tax advantage by making arrangements which divert his or her income to another person who is liable at a lower rate of tax or is not liable at all. HMRC has become more vigorous in applying the legislation to incorporations. Get advice if this affects you.
- You may have to incur extra costs such as for audits and filing requirements at Companies House. By filing accounts, you are making information publicly available which would otherwise be private.

2 Financing your business

Aim to structure borrowings for maximum tax relief (consult your accountant or tax adviser).

2.1 Always look at the **security** of any borrowings you make.

- If you are borrowing to invest in your business and it is a high-risk venture, you probably shouldn't do it. Can you afford to lose what you are providing as security — particularly if it is your family home?

2.2 Taking out a **mortgage** — or a second mortgage — on your domestic property and then lending the money to the business can be a cheap way of raising capital.

- Interest rates are lower than for conventional business loans.
- Some mortgages give you the flexibility to vary repayments according to your changing financial circumstances. You may be able to make overpayments or underpayments, repay lump sums or take payment holidays.
- One catch is that there is no mortgage interest relief in the UK.

2.3 Business **bank loans** are still relatively cheap.

- But make sure you will be able to cope with probable increases in interest rates.

2.4 You could structure your business to qualify for the **Enterprise Investment Scheme**.

- This helps certain types of small unquoted companies to raise capital by providing tax relief on investments of up to £500,000 for investors in these companies.
- Most trades qualify. Those that don't include hotels and guest houses, property development, and financial activities such as insurance and hire-purchase financing. Other conditions apply.

2.5 Think carefully about the best way to acquire a business **property**.

You could buy it in your own name and charge the business a rent.

Or you could create a small self-administered pension scheme for directors, who make contributions to the scheme and get tax relief on them. This buys the freehold to the property and rents it back to the business.

- Where resources are limited, such a scheme can help you buy a property while funding pensions at the same time.
- There is tax relief on the full cost of the building and the rent payable.
- The property must be purchased – and rent charged – at a commercial rate.
- The pension scheme can borrow to fund the purchase.
- No capital gains tax will be payable on a subsequent sale.
- The property will be protected against insolvency or bankruptcy as it will not be an asset of the individual or company.

➨You should consider protecting the value built up in your business by insuring against your illness, disability or death. A range of cover – including life, critical illness and 'key man' insurance – is available.

3 Extracting profits

This is probably the main financial-planning issue for owner-managers.

3.1 Look at your **taxable profits**, consider what you need to keep in the business and then what you need as an individual.

3.2 If you run a limited company, consider whether to take **profits** and if so, how.

- If you need money, you should pay yourself a salary or dividend. (Otherwise it may be better to make other investments, such as in a pension scheme.)
- Both attract income tax, but dividends can be cheaper for some small firms, as no employer's NICs are payable.
- The choice will depend on your individual earnings and corporation tax position – ask

your accountant for advice on this.
- Dividends do not qualify as relevant earnings for pension purposes (but see **4.3**).

3.3 Take advantage of a lower-earning spouse's **tax allowances** and reliefs.

- Consider paying them a salary to make use of their personal allowance for income tax and the National Insurance threshold. You may have to justify levels of remuneration to HMRC.
- Consider transferring shareholdings or other income-generating assets to your spouse to benefit from lower income-tax bands. Transfers must be outright to be effective.

Planning your inheritance

If you want to pass on the value of your estate to your family after your death, you will need to act to reduce your inheritance tax liabilities.

Assuming no lifetime gifts are made, no inheritance tax (IHT) is payable on estate values of less than £325,000 (£650,000 for spouses and civil partners). But above this, 40 per cent may be payable if you fail to plan.

- If your business is privately owned, shares held for at least two years will generally qualify for 100 per cent relief from IHT.
- Most lifetime gifts are exempt if you survive seven years from the date they are made.
- You can use your annual exemption – currently £3,000 – to make a gift free of IHT. Any unused portion of the exemption can be carried over to the next tax year.
- Small gifts of up to £250 can be made to any number of individuals in a tax year.
- Gifts between spouses and civil partners are usually exempt.
- Investing in stakeholder pensions for children and grandchildren can also cut your IHT liabilities.
- Trusts can allow you to make significant savings while keeping some control of your assets.
- Take care when writing your will. The wording can significantly affect your IHT liability – so consult a good solicitor.
- Be inventive with your will – an accountant can help. Leaving your assets to your spouse may not be the most tax-efficient option.

3.4 **Loan-backs** from a small self-administered pension scheme can be an effective and tax-efficient way of making sure your company has the money it needs. For example, say you have profits of £500,000 and the company needs £250,000. You could put £500,000 in a pension fund and pay no tax. You then loan back 50 per cent. Without such a scheme, you would need to retain more than £300,000 gross to keep £250,000 in the business.

- Loan-backs must be at a commercial rate of interest. The interest goes into the pension fund tax-free.
- A loan-back must be for a 'genuine business purpose'. Saying it is for cashflow is unlikely to satisfy HMRC – but stating it is for, say, PCs should be fine.

3.5 Look at how you remunerate your **staff**.

- Some elements of a remuneration package can cost you less than the value of the benefit received by the employee: mobile phones or computers, or pension contributions, for example.
- But others can be more costly.

4 Investments

4.1 When looking to make investments, consider the **accessibility** of your money as well as the potential gains.

- Do not put money in long-term investments if you might need quick access should the business run short of cash.

4.2 **Corporate investments** are not necessarily an important issue for small businesses.

- In a small firm, money put back into the business will always be at risk. What if the business folded and you were out of work without financial back-up?
- You will get greater personal security by taking money out of the business and putting it into investments such as ISAs, pension schemes, and so on. But this, may run contrary to your desire to expand the business.

4.3 The tax framework for **pensions** is being overhauled, but they continue to offer a tax-efficient, cost-effective way of saving for retirement.

- Pension contributions are generally more tax-efficient the earlier in life they are paid since they have longer to earn returns in a tax-exempt environment. Starting early also spreads the cost over a longer period.
- Current rules allow individuals to base pension payments on earnings from any one of the current or previous five years. So, for example, you could pay yourself a large salary this year and dividends for the next five, but continue to make pension contributions linked to this year's earnings. The NI savings can be significant. Alternatively contributions could be made for five years following retirement. In any case, you can at present pay in £3,600 a year gross regardless of earnings and still get full tax relief.
- Stakeholder pensions offer flexibility with low fixed charges. You can contribute regularly or occasionally to these money-purchase arrangements, and stop and restart payments without penalties. The business can also make contributions, with full tax relief.
- A Small Self-administered pension Scheme (SSAS) or a Self-invested Personal Pension (SIPP) gives you much greater control over your investments. A SSAS is set up by the company, which must make regular contributions, while a SIPP can be established by either an employer or an individual. You can make investments in a wide range of areas and change them as your performance targets – and willingness to accept risk – develop with age.
- Most types of pension scheme allow you to delay buying an annuity beyond retirement up to a maximum age of 75.

4.4 When annuity rates are at low levels, **individual savings accounts** (ISAs) could give you a similar net income to a pension fund.

- You continue to have access to the entire fund. With a pension, you only obtain control of the tax-free cash lump sum once you have purchased an annuity.
- Funds are only free from income tax and capital gains tax once they are in an ISA – you will pay tax and National Insurance extracting the money from the business.
- You can invest up to £7,200 a year (£14,400 for a married couple or those in a civil partnership). The rate will go up to £10,200 on 6 October 2009 for the over 50s, and on 6 April 2010 for everyone else.
- An ISA can be invested in equities and bonds, and up to £3,600 in cash and £1,000 in life assurance products.

4.5 **Enterprise Investment Schemes** and **Venture Capital Trusts** allow you to invest in other small unquoted trading companies.

- They offer a number of tax advantages, but can represent a high-risk investment.

5 Managing your exit

Shares in your business – like most other parts of your estate – may be subject to capital-gains tax (CGT) when you sell them. Start thinking about your exit from your firm in advance to make sure it is structured in the best way possible to reduce your CGT liabilities.

5.1 Capital gains up to your **annual exempt amount** of £10,100 are free of CGT.

- CGT is paid at a flat rate of 18 per cent on all gains over the annual exempt amount.
- Capital losses can be off set against gains from the same year. Any excess loss can be off set against gains in future years.

5.2 Individuals can claim **entrepreneurs' relief** on the first £1 million of gains made on the sale of the business or its assets.

- The relief gives an effective rate of ten per cent on gains up to £1 million.
- Claims can be made on more than one occasion up to the £1 million lifetime limit.
- Gains over the £1 million lifetime limit are charged at a flat rate of 18 per cent.

5.3 When selling a business, you may be asked to accept some of the payment in **loan notes** — which you may be able to use to defer payment of CGT.

- Structured correctly, you will not have to pay CGT until the notes are cashed.
- For commercial reasons, check that the loan notes are guaranteed by a bank.

5.4 Payment of CGT can be **deferred**.

- You may qualify for 'rollover relief' if you re-invest the funds from the sale of your business premises or assets in new business premises.
- Reinvestment relief is available if you reinvest your gain in qualifying shares in certain companies under the Enterprise Investment Scheme.
- Gains over the £1 million lifetime limit are charged at a flat rate of 18 per cent.

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