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About This Guide

All businesses, large or small, like to save tax and there are many simple steps that a business can take to achieve this aim.

This guide contains 101 tax savings tips aimed at entrepreneurs. The tips follow the lifecycle of a business meaning that there is something for everyone, regardless of whether you are thinking of starting a business, a new start-up or an established business. Many of the tips apply equally to sole traders, partnerships and companies, whereas some are specific to a particular type of business.

However, it should be noted that tips in this guide are for illustration purposes only and are intended to demonstrate where tax savings can be made. The savings that can be made will depend on the precise circumstances and the examples are a guide only. Professional advice should always be sought.

Chapter 1.
Business Structure

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1. Choose The Right Structure For Your Business

There are various ways in which businesses can be structured, and it is important that the structure that is chosen is the right one for the business.

There are four main options:

- sole trader;
- partnership;
- limited liability partnership; and
- limited company.

The choice of business vehicle affects the type of taxes you pay, your liability for business debts and the legal and administrative requirements imposed on the business. It will also affect the way in which business decisions are made and the sources of finance available to the business.

In deciding on the right structure for the business, it is necessary to take account of all relevant factors and also your attitude to risk.

For example, a sole trader is the simplest set-up and the proprietor gets to keep all of the profits. However, he or she is also liable for all of the business debts. The sole trader is taxed on his total income after deducting his personal allowances – the profits of the business are not taxed separately but form part of the sole trader's taxable income, together with income from other sources, such as any employment or investment income. A sole trader must also pay Class 2 and Class 4 National Insurance contributions if profits exceed the relevant trigger thresholds.

A limited company is more complicated to set up and administer, but the shareholders' liability is limited to the amount of capital that they own – a major plus. The company is taxed in its own right, and any profits that are extracted from the company will be taxed on the recipients. The tax position of the company is separate from that of the individual shareholders. The company must file annual accounts and an annual confirmation statement at Companies House. Being a director of a limited company also confers certain statutory duties.

Choose The Right Structure For Your Business

Bill wants to set up his own business. He has some money to invest but does not want to risk losing his family home if the business fails.

He is also keen to present a professional image to potential customers to help him win new business.

Having considered all the factors, Bill decides that a limited company is the right vehicle for his business. Limited liability is very important to him and he is prepared to undertake the additional administrative burden associated with a limited company in return for this.

2. Choose Which Taxes You Pay

The choice of business vehicle will also determine which taxes are paid by your business. Sole traders and partnerships pay income tax on their profits and Class 2 and Class 4 National Insurance contributions, whereas a limited company pays corporation tax. However, there may also be income tax to pay on profits extracted from a limited company and where those profits are extracted in the form of a salary or bonus, Class 1 NICs.

The profits from a sole trader's business and a partner's share of partnership profits are taken into account in working out his or her overall income tax liability, together with income from other sources, such as any employment income, taxable interest, and dividend income. Personal allowances are available to reduce the amount on which tax is charged. To the extent that business profits exceed the proprietor's personal allowance, they are taxed at 20%, 40% or 45% for taxpayers in the UK excluding Scotland (the Scottish rates of income tax apply to Scottish taxpayers). By contrast, the taxable profits of a company are taxed at the corporation tax rate of 19% (financial years 2019 and 2020). Profits extracted from the company as salary or bonus are liable to income tax and also Class 1 National Insurance contributions. However, salary and bonus payments and the associated employer's National Insurance are deductible in computing profits chargeable to corporation tax. There is no corporation tax deduction for dividends, which must be paid out of retained profits, but in the hands of the shareholder, they are tax-free to the extent that the dividend allowance is available and otherwise at the relevant dividend rate of tax.

Gains realised by individuals are liable to capital gains tax, whereas a company pays corporation tax on chargeable gains.

All businesses with turnover of VATable goods and services above the VAT registration threshold, currently £85,000, must register for VAT. All businesses with turnover below this level can choose to register if they wish, but this is not compulsory. VAT-registered businesses with turnover above the VAT registration threshold of £85,000 must comply with the requirements of Making Tax Digital. Where the business is VAT registered but turnover is below this level, compliance with MTD for VAT is optional.

A sole trader and an individual partner in a partnership are self-employed and pay both Class 2 flat rate National Insurance contributions and Class 4 contributions on their profits if their profits exceed the relevant profit thresholds. It is the payment of Class 2 National Insurance contributions that builds up entitlement to the state pension and certain contributory benefits.

Companies do not pay National Insurance on their profits but must pay employer contributions on payments of earnings made to employees.

By choosing the structure for your business, it is also possible to choose which taxes you pay – the taxes that are paid vary depending on the structure of the business.

Choose Which Taxes You Pay

Richard wants to set up a business. Having considered the options, he decides that being a sole trader is the right decision for him.

Richard will pay income tax on any profits from his business. His income tax liability will depend on his total income from all sources.

He will pay capital gains tax on any capital gains made from the sale of business assets, etc.

He will also need to register for Class 2 National Insurance contributions and will also pay Class 4 contributions on his profits.

If his turnover exceeds the VAT registration threshold, he must also register for VAT. If his turnover is below this level, he can register voluntarily as this will allow him to recover any VAT suffered, although he must also charge VAT on any VATable supplies that he makes.

3. Take Advantage Of The Veil Of Incorporation

Sole traders have unlimited liability for any debts that their business incurs. By contrast, a shareholder is only liable for company debts up to the amount of any share capital that they own. Limited liability is one of the main advantages of choosing to run your business as a limited company rather than as a sole trader or partnership.

A limited company is a separate legal entity from its shareholders and directors. This is known as the veil of incorporation. The shareholders' and directors' personal assets are not available to meet the debts of the company. However, the money and assets of the company belong to the company rather than to the shareholders personally.

By contrast, where an individual operates a business as a sole trader, there is no legal distinction between his or her business and private affairs. This means that the individual is personally liable for any business debts.

Take Advantage Of The Veil Of Incorporation

Jack has set up in business as a limited company. He has 100 £1 shares that are fully paid up. He is the sole shareholder.

The business collapses with debts of £10,000. Jack is not personally liable for those debts. His liability is limited to his shareholding of £100.

4. Save Incorporation Costs

A limited company must be properly created in accordance with company law requirements and registered with Companies House. This process is known as incorporation.

Although a company formation agent, accountant, solicitor or chartered secretary can be used to incorporate the company in return for a fee, it is possible and relatively straightforward to set up the business yourself. Guidance on how to do this can be found on the Gov.uk website at www.gov.uk/limited-company-formation/register-your-company. A company can be registered online if it is limited by shares and it uses the standard article of association (also known as the 'model articles'). This service costs £12 and the company is normally registered within 24 hours. The same service can be used to register the company for corporation tax and to register for PAYE.

It is also possible to register a company by post using form IN01. The stated timescale for postal applications is 8 to 10 days and the service costs £40. A same day service is available as long as the application is at Companies House by 3 pm. This service costs £100.

However, you may wish to seek professional advice prior to setting up a company, particularly as regards to what is the appropriate share structure for your business to facilitate the tax efficient extraction of profits (see Tip 5).

Save Incorporation Costs

Bill investigates the process of setting up a company for his new business. He wants to keep costs to a minimum and uses the online incorporation service offered on the GOV.UK website. This is straightforward to use and costs him only £12.

5. Create Different Categories Of Shares In A Limited Company

One of the limitations of a limited company when it comes to setting an efficient profit extraction strategy is the need to pay dividends in proportion to shareholding; dividends are declared 'per share'. To overcome this limitation, when setting up a limited company, consider creating different classes of shares to allow the flexibility for different rights to be attributed to different shareholders. Because dividends must be paid out in accordance with shareholdings, by creating different classes of shares it is possible to declare a dividend for one class and not for another, or to declare different dividends for different classes of shares. This allows the flexibility to extract profits in a tax-efficient manner. A share structure of this nature is often referred to as an alphabet share structure, as the company can create A class shares for one shareholder, B class shares for another shareholder and so on.

Likewise, attaching different voting rights to different shares allows the decision making to be vested in one person but for another person to receive a greater share of profits.

If an alphabet share structure is not created at the outset, it is possible to create different classes of shares at a later date, as long as this is permitted by the articles of association.

When using an alphabet share structure, it is sensible to plan ahead to ensure that the shares meet the conditions for Business Asset Disposal relief (previously entrepreneurs' relief) (see Tip 100).