Exploring incorporation

Nick Hancock and **Tracey Watts** discuss how to benefit from incorporation.

As dentists are now able to operate through limited companies, many have incorporated in recent years, taking advantage of attractive tax savings to be had on transferring goodwill to the company, as well as receiving tax relief on the goodwill write down in the company where the business either started after April 1, 2002, or was acquired from an unconnected party. Such a transfer would typically involve selling the goodwill to the company, with capital gains tax being paid at 10 per cent under entrepreneur relief (ER) rules, in return for a large loan account that could then be drawn down on tax free.

The dentist has then also➲

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benefited from further ongoing tax savings, once his loan account has been exhausted, by taking profits out as a mix of basic salary, topped up by dividends, and then often making even more savings by introducing their spouse into the business as a shareholder.

For businesses transferred to a limited company post December 3, 2014, ER will not be available where goodwill is transferred to a company related to the transferor. A related company will broadly be one owned by the dentist, or any of his business partners or relatives.

This means a tax charge at 28 per cent will now apply to any gain realised on the disposal of goodwill during an incorporation of a business, although there are ways to defer this charge depending on how the business is incorporated. Alternatively, a 28 per cent charge might still be quite attractive if the dentist is making profits that would otherwise be taxable at 42-47 per cent.

In addition to the withdrawal of ER on goodwill from December 3, 2014, a company will no longer get full tax relief on the write down of the goodwill over the course of its useful life in many cases only getting relief for its cost on any eventual disposal of the business by the company will be available. This applies to related party incorporations from December 3, 2014 and to unrelated acquisitions from July 8, 2015.

Despite this, incorporations might still be attractive for many dentists. But what about the position for the outgoing dental practitioner when his practice is taken over and immediately incorporated?

Typical third party acquisition

Because of tax savings, and other commercial advantages of operating through a limited company, a typical dental practice acquisition might take the following form:

Robert is a practitioner at a mixed practice but wants to retire. He has agreed to sell his practice to David, who wants to run his business through a limited company. Robert and David are not relatives of each other and they have never been in business together before. David sets up his company, Pearly Whites, and Pearly Whites acquires all of Robert's dental equipment, practice fixtures, staff and private patient client lists and goodwill.

However, because of NHS contract restrictions, Pearly Whites cannot take over Robert's NHS contract on day one and instead David has to form a quasi-partnership with Robert for about two months, during which time the quasi-partnership earns income from the NHS contract and is charged a management fee by Pearly Whites for its share in the staff costs and plant use. Any profits made by the partnership are shared 99 per cent to David and one per cent to Robert. After the two-three month period, Robert retires from the quasi-partnership and David then subcontracts his NHS contract to Pearly Whites.

Provided the formation of the quasi-partnership does not take place until immediately after Robert sells his private practice business to Pearly Whites, Robert shouldn't be treated as selling his private practice to a related company and so should benefit from ER on the disposal of the goodwill attached to that part of his business. He will also get ER on his disposal of his 99 per cent interest in the remaining part of the business to David, plus further relief when he exits entirely. Robert should therefore pay capital gains tax at only 10 per cent on his retirement.

For Pearly Whites, it should still get tax relief on the write down of goodwill purchased from Robert over its useful life to the company, but only if he acquired the practice before July 8, 2015.

Conclusion

The tax position for this type of practice acquisition has therefore become more complex since the rules changed on December 3, 2014 and the order of transactions can be imported. Relationships between the practitioners should be carefully considered by always taking advice ahead of any transaction.

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