



In this briefing we summarise the relevant tax changes and examine whether it is still more attractive to continue to operate your business through a company rather than self employment.

Incorporation or not - are there any tax savings still left?

The issue of whether to run your business as a company, a sole trade or a partnership continues to be very much a 'hot topic' of the moment. This is due to a combination of changes to the tax system over recent years. These have generally combined low rates of corporation tax with no national insurance on dividends. This has meant that many self employed businesses were transferred into companies to obtain tax savings. In March 2007 Gordon Brown held his last Budget and announced a series of changes to the tax system over the next three years.

Summary of relevant changes to the tax system announced in Budget 2007

Rate of corporation tax for small companies

- The small companies' rate of corporation tax, that applies to companies with taxable profits up to £300,000 per year, increased from 19% to 20% from 1 April 2007.
- The marginal rate of tax for profits between £300,000 and £1,500,000 was reduced slightly.
- Gordon Brown also announced further increases in the small companies' rate to 21% from 1 April 2008 and 22% from 1 April 2009.

In summary, the corporation tax rates for the next three years will be:

| | 2007/08 | 2008/09 | 2009/10 |
|-----------------------|---------|---------|---------|
| Main rate | 30% | 28% | 28% |
| Small companies' rate | 20% | 21% | 22% |
| Marginal rate | 32.5% | 29.75% | 29.5% |

This is in contrast to lower rates over recent years, with a 0% rate only five years ago.

Income tax

For 2007/08 there is no change to income tax rates. The starting rate remains at 10%, the basic rate at 22% and the higher rate at 40%. As usual the bands were extended, so that for 2007/08 the 10% starting rate applies to the first £2,230 of taxable income and the basic rate applies to taxable income from £2,231 up to the new higher rate threshold of £34,600.

However, Gordon Brown announced in the Budget a reduction in the basic rate of income tax to 20% in 2008/09

and the removal of the 10% starting rate for non-savings income. This means that the 10% starting rate will continue to apply to savings income, such as bank interest and dividends, and capital gains.

Also in 2008/09 the basic rate band will be increased by inflation only. For 2009/10 the basic rate band will be increased by an additional £800 above inflation to align with the upper earnings and profits limits for Class 1 and Class 4 national insurance.

National Insurance Contributions (NICs)

For 2007/08, there were no particular changes announced to the NICs regime. The bands went up by inflation but the main rates remained unchanged:

- 12.8% employers' NICs
- 11% employees' NICs with an additional 1% on earnings over the upper earnings limit
- 8% self employed NICs with an additional 1% on earnings over the upper profits limit plus regular weekly contributions.

For 2008/09 the upper earnings limit for employees' NICs will be increased by an additional £75 per week (£3,900 per annum) above inflation. The upper profits limit for the self employed will also increase by £3,900 per annum above inflation.

So what do these proposed changes actually mean?

The fact that Gordon Brown only gave us an outline of the changes and not the full facts and figures makes the series of changes even more complicated!

However, in summary, the plans for income tax bands on earned income and NICs are as follows:*

| Tax Year: | 2007/08 | 2008/09* | 2009/10* |
|---|---------|----------|----------|
| Income tax | | | |
| Personal allowance | 5,225 | 5,225 | 5,225 |
| Starting rate band | 2,230 | Nil | Nil |
| Basic rate band | 32,370 | 34,600 | 35,400 |
| Higher rates start at: | 39,825 | 39,825 | 40,625 |
| NICs | | | |
| Lower earnings limit (no NICs) | 5,225 | 5,225 | 5,225 |
| Upper earnings and upper profits limits | 34,840 | 38,740 | 40,625 |

* (ignoring increases expected due to inflation)

At first sight, a self employed person appears to benefit compared to a company, given the proposed reduction in the basic rate of tax that the self employed pay and the increase in corporation tax. In addition, the government is also intending to align the upper limit of the basic rate band with the upper earnings limit for NICs by 2009/10. This will mean that in 2008/09 and onwards:

- the unincorporated business will pay more NICs at 8% rather than 1%;
- if a company is paying out a salary to the director/shareholder above the current basic rate band, there will be more employees' NICs at 11% rather than 1%.

The potential savings on incorporation will depend on a number of factors but the example below shows the level of savings that could be made. The essence of the savings continuing to be made compared to remaining unincorporated is that the shareholder/director can choose not to suffer the extra Class 1 NICs by extracting profit as dividend rather than salary.

What does this mean to the extraction of profits from a company?

Over recent years, the tax savings to be made from incorporating a business have often revolved around combining the low rates of corporation tax with the fact that there are no NICs payable on dividends. If a director/shareholder is a higher rate taxpayer, the benefit of paying a dividend or bonus is dependent upon the effective corporation tax rate of the company. How have the changes announced by Gordon Brown affected the position for 2007/08?

Example - small companies rate of corporation tax (CT) applies

Christie is to receive a bonus of £60,000 after all taxes from his family company. He has a marginal income tax rate of 40% (32.5% if dividends) for 2007/08 and already has earnings above the employees' upper earnings limit for NICs purposes so that any bonus will be liable to employees' NIC at 1%. The company pays CT at the small companies' rate of 20%. We have prepared the following comparison of the cost of paying a dividend rather than additional remuneration to Christie for the tax year 2007/08.

| | Dividend £ | Bonus £ |
|----------------------------------|----------------|----------------|
| Christie | | |
| Dividend/remuneration | 80,000 | 101,695 |
| Less: National Insurance (1%) | | 1,017 |
| Add: Tax credit (1/9) | 8,889 | |
| | 88,889 | |
| Less: Income tax (@ 32.5% / 40%) | 28,889 | 40,678 |
| NET RECEIPT | £60,000 | £60,000 |

| | Dividend £ | Bonus £ |
|-------------------------------|----------------|----------------|
| Company | | |
| Payment by company | 80,000 | 101,695 |
| Add: Employers' NIC (@ 12.8%) | | 13,017 |
| | | 114,712 |
| Less: Tax relief (@ 20%) | | 22,942 |
| COST TO COMPANY | £80,000 | £91,770 |

Example - main rate of CT applies

If the company pays CT at the full rate of 30%, the bonus route is slightly more expensive than the dividend route.

| | Dividend £ | Bonus £ |
|---|----------------|----------------|
| Christie (figures as last example) | | |
| Company | | |
| Payment by company | 80,000 | 101,695 |
| Add: Employers' NIC (@ 12.8%) | | 13,017 |
| | | 114,712 |
| Less: Tax relief (@ 30%) | | 34,414 |
| COST TO COMPANY | £80,000 | £80,298 |

Example - marginal rate of CT applies

If the company has profits above £300,000 before a bonus is deducted, the marginal rate of CT is 32.5% and so the cost to the company of a bonus is less than the cost of a dividend ie:

| | Dividend £ | Bonus £ |
|-------------------------------|----------------|----------------|
| Company | | |
| Payment by company | 80,000 | 101,695 |
| Add: Employers' NIC (@ 12.8%) | | 13,017 |
| | | 114,712 |
| Less: Tax relief (@ 32.5%) | | 37,281 |
| COST TO COMPANY | £80,000 | £77,431 |

What is the position in future years?

By 2009/10, the CT rates are expected to be 28% main rate, 22% small companies' rate giving a marginal rate of 29.5%. The costs of a bonus in any of these scenarios will be:

| | 22% | 28% | 29.5% |
|---------------------------------|---------------|---------------|---------------|
| Cost of bonus before tax relief | 114,712 | 114,712 | 114,712 |
| CT relief | 25,237 | 32,119 | 33,840 |
| Cost to company | 89,475 | 82,593 | 80,872 |

Conclusion

Despite many of the changes announced by Gordon Brown, running a business through a limited company still enables tax savings to be made.

But remember: never let the tax tail wag the commercial dog! Companies bring extra formalities, costs and responsibilities, so no decision to run a business through a limited company should be undertaken lightly.

Please get in touch with us if you would like to discuss any of the issues raised in this briefing.

Case study

Anthony makes annual profits of £60,000. His year end is 31 March.

A comparison of his position as a sole trader or if he incorporates (taking a salary of £5,225 and the balance as dividend) is as follows:

| | 2007/08 £ | 2008/09 £ | 2009/10 £ |
|---------------------------------------|---------------|---------------|---------------|
| Profits before salary if incorporated | 60,000 | 60,000 | 60,000 |
| Salary | 5,225 | 5,225 | 5,225 |
| Dividends if incorporated | 43,820 | 43,272 | 42,724 |
| Taxes payable: | | | |
| As sole trader | £ | £ | £ |
| Income tax | 15,414 | 14,990 | 14,830 |
| NIC | 2,735 | 3,008 | 3,140 |
| Total | 18,149 | 17,998 | 17,970 |
| Taxes payable: | | | |
| As company | £ | £ | £ |
| Income tax on salary | Nil | Nil | Nil |
| NIC on salary | Nil | Nil | Nil |
| Higher rate tax on dividends | 3,170 | 3,033 | 2,716 |
| Corporation tax | 10,955 | 11,503 | 12,051 |
| Total | 14,125 | 14,536 | 14,767 |
| Extra taxes payable if unincorporated | £4,024 | £3,462 | £3,203 |

Analysing the figures for 2009/10:

| Unincorporated business | Income tax £ | Class 4 NIC £ |
|--------------------------|-----------------|------------------|
| 5,225 personal allowance | - | - |
| 35,400 @20% | 7,080 | 2,832 |
| 19,375 @40% | 7,750 | 194 |
| £60,000 | 14,830 | 3,026 |

| | |
|--------------------------|----------------|
| Class 2 NIC 52 x £2.20 | £114 |
| Total tax and NIC | £17,970 |

| As company | £ | £ | £ |
|---|---|---|---------------|
| Profits | | | 60,000 |
| Less: | | | |
| Salary | | | (5,225) |
| Employers' NIC | | | Nil |
| Profit chargeable to Corporation tax | | | 54,775 |

| Corporation tax | | | |
|--------------------------------------|-------|---------------|---------------|
| 0 to 300,000 | 22.0% | 54,775 | 12,051 |
| 300,001 to 1,500,000 | 29.5% | Nil | Nil |
| above 1,500,000 | 28.0% | Nil | Nil |
| | | 54,775 | 12,051 |
| Profit after tax (= dividend) | | | 42,724 |

| | | |
|--|--------|----------------|
| Higher rate income tax | | |
| - Dividend plus tax credit | 47,471 | |
| - Lower tax rate band and allowances available | 35,400 | |
| - Excess over basic rate band | 12,071 | @22.5% = 2,716 |