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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