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INCREASE YOUR ONLINE SALES

By Jennifer Johnson

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According to a new survey carried out by Alliance & where ID_NUM=9270; Leicester, one in five small business owners view tax as their greatest concern. The Chancellor has announced in his last budget that companies with profits below oe10,000 will not have to pay any corporation tax with effect from 1 April 2002. The question to be asked is: does that announcement make incorporation a more attractive option compared to being a sole trader?

The answer is that from a tax point of view, it is advantageous to trade through a limited company as long as the income is drawn from the company by the owners as dividends from their shares and the amount of dividends drawn is restricted below the 40% band rate (i.e. oe31,063 for tax year 2002/03). That way, the owners have no further personal tax ("income tax") to pay. Moreover, dividends are not subject to national insurance contributions. This is excellent news of course. But, if dividend income falls within the higher rate bracket of income tax (i.e. above oe34,515), they will be taxed at 22.5% on the excess, which of course will increase the tax burden. The company profits are subject to corporation tax rates. Those are lower than income tax rates.

The most catastrophic scenario is when the director takes his reward from the company as salary. Then his/her salary is taxed at income tax rates (like a sole trader's income). That is because, unlike sole traders, the tax system treats companies as separate from their owners because a company is

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a separate legal entity. The problem is that the income taxes are higher than corporation tax rates. On top of that, they will be subject to employee and employer national insurance contributions, which of course increase the tax burden and render his position worse than even an unincorporated business ("sole trader"), because NIC Class 1 on payroll are higher than NIC Class 2 paid by self employed.

In contrast, a self employed person ("sole trader") is taxed at income tax rates on the profits from his business, which are added to his other sources of income. As it has already

been mentioned, income tax rates are overall higher than corporation tax rates. On top of income tax, national insurance contributions class 4 are payable on the business profits within a specified band (7% on profits between £4,615 and £30,420). National insurance contributions Class 2 are also paid by self-employed people, although those are lower than those payable by company directors on their salaries.

To illustrate the above, let's take a simple example. We have a limited company and a sole trader. They both make £60,000 profits each in the tax year 2002/03. We assume that the company director takes a salary equal to the amount of his personal allowances (untaxed income) of £4,615 and the balance as dividends. The company will pay corporation tax at 19% equal to £10,523 and nothing else. The sole trader will pay income tax £16,542, National insurance Class 2 £104 and National insurance Class 4 £1,806. Total £18,452. The bottom line is that the person that has incorporated his business into a limited company will make a tax saving of £7,929 compared to a sole trader! Isn't that fantastic?

Somebody might be wondering: why is this entire happening? The official explanation is that, this government, to help the economy grow, encourages people to leave as much profits within their businesses to be reinvested, instead of being taken out and spent.

The "unofficial line" is that, as a matter of fact, for years the Inland Revenue has tried to reclassify the self-employed. The 1% in NIC hike on staff salaries above the NIC threshold from next April adds to both the

employees' and employers' tax burden and may more than offset the saving from the corporation tax zero rate on the first of 10,000 of profits.

Aren't there any other matters to consider in deciding whether to incorporate or not?

Higher administration costs to comply with company law, payroll and bookkeeping is one factor. Another issue is pension planning. Extracting profits out of the company as dividends rather than salary means that there will be no "net relevant earnings" and therefore pension contributions can't be made. But the advent of stakeholder pension plans has meant that contributions up to £3,600 per year can be made without the need for any earnings. If a person does not wish to transfer funds in existing plans into stakeholder because of high charges, there is a way out: the best net

relevant earnings (i.e. salary) in five consecutive years can be used for making contributions for the next five years, even if there were no salaries in the remainder four years. It is comforting to know that entitlement to basic state pension is not affected by taking a salary from the company at the level of a person's personal allowances i.e. £4,615.

Furthermore, an individual may decide not to bother with pension plans and instead invest in ISA. Often, these can be more efficient than pensions but that's beside the scope of this article. If that option is taken, no salary is necessary.

Another factor is business motoring. It might be tax advantageous for an unincorporated business that owns many cars not to incorporate because if these cars have some private use there will be benefits in kind taxed on the users. These are generally higher than the straight apportionment between private and business for all car running costs in the case of sole traders.

The conclusion is that there can be considerable tax savings waiting the sole trader who decides to go down the road to incorporation. But, one needs to proceed with caution and careful planning. And don't forget the biggest advantage of incorporation, which is Protection

from Personal Liability. Incorporating is one of the best ways to protect a business owner from personal liability. Shareholders of a company are generally not liable for the obligations of the company. Creditors of a company may seek payment from its assets, but not the assets of the shareholders. This means that business owners may engage in business without risking their homes or other personal property.

Thank you for taking the time to read this Article. I hope you've found it useful. If you have, please drop me an email and let me know what you think.

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Jennifer Johnson is the owner of Logo Design Zone. She can create a 100% unique, totally memorable logo for your business – for UNDER \$200! Does your current logo make the grade? Take LogoDesign Zone's free logo quiz and find out!

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By Marsh Uele

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