Broadcast

FACTSHEET: TAX DRIVEN INCORPORATIONS

SPECIAL ISSUE

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THE FUTURE FOR TAX DRIVEN INCORPORATIONS

Transferring a sole trade business to a limited company was historically an easy way of saving tax and national insurance (NI). However, a succession of changes since 2016 have largely mitigated the tax efficiency of the basic low salary and dividend planning strategy.

Up to 2021/22

To illustrate the impact of the change, consider the final year under the old system — 2015/16. A sole trader with profits of £100,000 would keep just over £66,200 after tax and NI. However, a director/shareholder of a single person company would keep just over £71,000 - a saving of almost £5,000.

2022/23

The same sole trader with the same profits will now keep £66,800. The director/shareholder will still be better off with just over £68,600, but the saving has been drastically reduced due to the increased tax rates on dividends to 8.75%, 33.75% or 39.35%.

2023/24

However, from April 2023, the main rate of corporation tax for companies with profits over £50,000, will in effect increase to 25%. Companies with profits in excess of £50,000 will be charged at 25%. However, where profits do not exceed £250,000, marginal relief can be deducted to reduce the effective rate of tax on the excess. Profits not exceeding £50,000 will continue to use the small profits rate of 19%.

This change will have a significant impact on the decision to incorporate going forward.

The sole trader is in more or less the same position as for 2022/23, keeping just under £67,000 of their profit after tax and NI, as sole trade profits are not subject to corporation tax.

However, the director/shareholder's position is affected because the corporation tax bill will increase compared to 2022/23, leaving less distributable profits to take as a dividend. They will keep just £67,000, putting them on a par with a sole trader.

The future for incorporation

Therefore, when considering whether to incorporate following the 2023 corporation tax rate increase, it is unlikely to be worth doing so from a purely tax-motivated angle, unless it is fairly certain that profits will remain within a fairly narrow band, around £50,000 to £75,000. However, the tax efficiency could be increased in a number of ways depending on the circumstances.

1. For example, the director/shareholder may not require all the profit to be extracted every year. Profits left undrawn as dividends will still be subject to corporation tax of course, but will not be subject to income tax until they are withdrawn. If this takes place in a later year, perhaps when profits are lower, or post-retirement, they could be subject to a lower rate of dividend tax.

2. The undrawn profits could also be put to use for the company to make investments in its own name. This could increase the distributable profits going forward.

3. Alternatively you could use the undrawn profits to make pension contributions by the employer. These would be deductible for corporation tax. The downside is that the money is then locked away until pensionable age is reached, but if working with your Financial Adviser, contributing to a pension is part of your long term planning, thus could be tax-efficient.

4. If these options are not suitable, i.e., because the director/shareholder needs as much money as possible from the company each year, an alternative strategy could be to bring a spouse or civil partner in as a second director/shareholder.

   This would eliminate secondary class 1 NI contributions, as the employment allowance would then be available. It would also have a drastic effect on the corporation tax and income tax charged.

   Firstly, assuming there is no other income, both directors would withdraw a salary, saving corporation tax of up to 25%. Secondly, the income paid out to the individuals would enjoy the benefits of two personal allowances, basic rate bands and dividend allowances.

   Assuming the dividend is split equally and neither director/shareholder breaches the higher rate threshold, the income tax bill will be less than £5,000. Overall, the change to a two-person company saves over £12,000 taxation, leaving our happy couple with £79,200.

To sum up, the days of the old 'one-man (or woman) band' companies may be numbered, but as highlighted above, there is certainly still a place for incorporation with tax saving in mind. Obviously, this is subject to future attacks by the Government.

Profit extraction for 2022/23

The surprise announcement of the Spring Statement in March 2022 was undoubtedly the decision to increase the NI payment thresholds, including the primary threshold to the level of the income tax personal allowance. However, this has been complicated by the fact that the primary threshold increase takes place from July rather than the start of the year.

In previous years, it has generally been optimal to restrict this to the level of the secondary threshold, unless the employment allowance is available (where a salary equal to the personal allowance is slightly better).

For 2022/23, the optimum salary for a director with no other income outside salary and dividends will be £11,908 following the change to the primary threshold. If the employment allowance is available, it will still be very slightly more efficient to increase this to £12,570, but in practice the difference is minimal.

For more information, please contact us. Call us on **01753 888211** or email **info@nhllp.com**