Income tax and Corporation Tax

Eventually, you will have to deal with income or corporate taxes. The taxation legislation is extensive and can be confusing for an individual starting a business. This chapter does not cover all the tax ramifications of a new business, nor does it detail all the expenses you can claim for, nor does it give details of allowances available on the purchase of some capital items.

A Chartered or Certified Accountant should be consulted when you are dealing with the taxation affairs of the business. The payment of taxation has a direct impact on your cash flow.

Continued

Which Accounting Year Should I Choose?

If you expect profits to rise steadily year by year, in the case of sole traders/partnerships, an accounting date early in the tax year, for instance 30 April, might be best in the short term, because this will defer the payment of tax on your profit. However, it is important to consider what will happen when you retire.

Any accounting date other than 31 March will cause a bunching of your tax liabilities because all your profit that has not been assessed prior to your retirement will be assessed for your final year.

There are a number of ways to mitigate the effect of this. You could plan to retire on or shortly after the accounting date and allow "overlap relief" to reduce the burden. You could build up a reserve to meet the liability or use the higher profit to provide funds for a larger pension contribution which can reduce your tax bill.

On the other hand, if you expect to make losses in your early years, an accounting date late in the tax year, for instance, 31 March, will ensure that you get tax relief for those losses as quickly as possible. You would then not be faced with the bunching problem on retirement referred to above.

It will also be necessary to bear in mind the seasonality of your business. As part of the profit for your first period of trading could be taxed twice, it would be unfortunate if a poor choice of accounting date were to accelerate the tax on the profit of your first busy period. In these circumstances it might be preferable to run your first accounts to a date just short of your peak period.

As ever, it is important not to overlook commercial considerations. Your bankers might want to see as healthy a profit as you can manage, and this desire could conflict with tax planning. A solution would be to choose a tax efficient tax accounting date and keep the bank happy with quarterly management accounts.

Tax Rates: Companies

Companies are charged corporation tax at the rate applicable during the financial year (1 April - 31 March). Where a company's accounts period spans two financial years the profits for the period are apportioned between the years.

The corporation tax rate used to change most financial years, but since 1 April 2017 the rate for almost all companies has been 19%, irrespective of their level of profits. Budget 2021 announced that the rate would be increased to 25% from 1 April 2023 where profits exceed £250,000 a year. From that date the 19% rate would only apply to profits up to £50,000 a year with a marginal rate of 26.5% for profits for profits between the two new thresholds.

The £50,000 and £250,000 thresholds are pro-rated for short accounting periods and also divided by the number of limited companies under common control. Consequently, from a corporation tax perspective it will not be advantageous to set up lots of companies.

Corporation tax self-assessment requires a company to calculate its own liability to corporation tax and pay that liability by the normal due date, nine months after the end of the accounting period, without an assessment being raised.

The company is required to send its completed self-assessment tax return (form CT600), accounts and tax computation to HMRC by the filing date, which is 12 months after the end of its accounting period. Penalties will be charged if it is late. These accounts and returns need to be submitted online to HMRC in iXBRL format. We can deal with this on your company's behalf.

HMRC may generally have 12 months from the filing deadline (24 months after the accounting period) to open an enquiry into the company's corporation tax return, otherwise the self-assessed figures are considered final. If additional tax is determined to be payable, interest (and possibly penalties) will be charged on the additional tax due.

Continued

Sole Traders / Partnerships

Sole traders and partnerships are charged income tax at the rate applicable during the fiscal years (6 April - 5 April). The rates are as follows:

	2020/21	Rate	2020/21	Rate
Lower	*see below	0%	*see below	0%
Basic - Next	£37,500	20%	£37,500	20%
Higher - Over	£37,500	40%	£37,500	40%
Additional - Over	£150,00	45%	£150,00	45%

*A zero-starting rate for savings income up to £5,000 is available but this rate does not apply if taxable non-savings income exceeds that amount. The first £2,000 of dividend income is tax free. In addition, the following amounts of interest income will be tax free:

- £1,000 a year interest tax free for basic rate taxpayers
- £500 a year interest tax free for higher rate taxpayers

Tax free interest will not be available to those with income in excess of £150,000 a year.

There may also be a liability to Class 2 and Class 4 National Insurance Contributions, depending on the level of profit in each fiscal year. Class 2 contributions are at a weekly rate of £3.05 (2021/22). Class 4 NI is payable by the self-employed on profits.

Class 4 contributions are levied at 9% on profits between £9,570 and £50,270 for 2021/22. There is a further 2% charge for 2021/22 on profits in excess of the upper limit.

For the self-employed and those that pay tax on other income such as rents, tax is normally payable in three instalments - the first two instalments are based on the tax paid on the previous year's business tax liability. Therefore, half is paid by the 31 January in the year of assessment, the other half by the 31 July in the year following the year of assessment.

The third instalment will be any balance due (payable the following 31 January) or any amount repayable by the Inland Revenue if your final liability is lower than the amounts paid on account.

However – a word of warning when you start up an un-incorporated business.....depending on accounting dates chosen and when you start to trade, you may not pay any tax on profits for some considerable time (for example if you start to trade on 1 May 2021 and first accounts run to 31 March 2022). You will not pay any tax on 31 July 2021 or 31 January 2022, nor will you pay any tax in July 2022. So, the first tax liability won't arise until 31 January 2023. This will be 100% of the tax liability for the period to 31 March 2022.

In addition, you will also have to pay 50% of that sum "on account" for the following tax year, with a further 50% in July 2023. You are then in the six monthly "cycle" and we can work with you to estimate the tax payments so that you can budget and set the money aside. Don't forget you will need to set aside Class 4 NICs (at 9% between £9,570 and £50,270) in addition to income tax

A lesson to take on board is to ensure that your accounts are prepared as soon as possible after the end of the accounting period. In our example of a 31 March year end, if accounts can be prepared before 31 July it will be possible to calculate the tax for the year to 31 March and the July 31 instalment can be adjusted accordingly – downwards if tax due is found to be less. If tax due is actually more for the year, there is at least early knowledge of the tax bill due in the following January.

Under self-assessment your income tax return, which encompasses your trading results, needs to be filed by 31 January following the tax assessment year. This date is moved forward to the end of September if you wish the Inland Revenue to calculate your tax liability. We will however file the returns electronically and perform the tax calculations on your behalf.

Continued

Taxation of Dividends

An important factor to consider when deciding whether to trade via a limited company or as an unincorporated business is the total amount of tax payable, not just the rate of tax on the profits. The current 19% rate of corporation tax makes a limited company appear very attractive. However, the shareholder/director then has to pay tax personally on the profits that he extracts from the company, so there is effectively double taxation.

A big cost here is national insurance, payable by both the employer and employee on amounts extracted as a salary or bonus. Many owner-managed companies have tended to extract profits by paying themselves a low salary, with the balance being paid out as a dividend to minimise NICs.

Individuals will pay no income tax on dividend income received up to £2,000. However, dividend receipts in excess of £2,000 will be taxed at:

- 7.5% for basic rate taxpayers (previously effectively 0%)
- 32.5% for higher rate taxpayers (previously effectively 25%)
- 38.1% for additional rate taxpayers (previously 30.56%)

The new dividend rates have resulted in a significant tax increase for owners of small companies, who have for some years been able to extract profits from their business with a tax-efficient mixture of salary and dividends. The chancellor's justification was to make tax-motivated incorporation less attractive, although arguably still more tax efficient than trading as an unincorporated business.

Example

In 2021/22, Alan and his wife each take a dividend from their company of £37,700 (gross, no tax credit) and a salary equal to their personal allowance of £12,570. They pay tax at 7.5% on £35,700 of that dividend, after deducting the dividend tax allowance of £2,000. In 2021/22 they will each pay income tax of £2,678 on their dividends, totalling £5,356 for the couple. In addition, they would each pay £300 NIC on their salaries and their company is liable to pay 13.8% employers NIC on the salaries in excess of £8,840. However there is an employment allowance of £4,000 available to set against the company's employers NIC liability.

If they had been a partnership with profits at a similar level, they would have paid about £6,000 more in tax and national insurance between them compared to corporation tax, income tax and NICs.

Tax Credits

Whilst not specifically related to "tax" despite the name, we will mention Tax Credits at this stage. There are two elements - Child Tax Credit and Working Tax Credit, although these are gradually being replaced by a new system of Universal Credits.

Child Tax Credit (CTC) is for families who are responsible for at least one child or qualifying young person. You should claim if you have a child or qualifying young person who usually lives with you. You do not have to be working to claim CTC.

Working Tax Credit (WTC) is for people who are employed or self-employed (either on their own or in a business partnership), who:

- get paid for their work
- expect to go on working for at least 4 weeks

And who are either

- aged 16 or over and responsible for at least one child, and usually working at least 16 hours a week, or
- aged 16 or over and disabled, and usually working at least 16 hours a week, or
- aged 25 or over and usually working at least 30 hours a week, or
- aged 50 or over and are starting work after receiving certain benefits for at least 6 months and usually working at least 16 hours a week, or
- aged 60 or over and work at least 16 hours per week

WTC is made up of several elements which we do not have space to list here.

If you are married or living with a partner, you'll need to make a joint claim for tax credits. You can only make a single claim if you don't have a partner.

When starting up it may be that your income precluded you from claiming tax credits in the past. However, income may drop substantially or a "loss" for both income tax and tax credits purposes may be able to be created by claiming allowances on equipment etc.

Claims can only be backdated for three months from the date of application, so it is advisable to contact the Tax Credits office as soon as possible to make a claim. You may not be immediately eligible based on a provisional calculation which takes into account your income in a prior tax year, but you may become entitled to it at some stage.

Telephone the Tax Credits helpline on 0845 300 3900.

Child Benefit

This basic credit is payable by reference to the number of children of the claimant. From 7 January 2013, an income tax charge has applied to this benefit where a claimant, their spouse, civil partner or person living with them earns over £50,000 per annum. The charge is 1% of the child benefit received for every £100 of the higher earner's earnings that exceeds £50,000 in the tax year.

So, if either you or your partner's income is £56,000, you will be taxed on 60% of the child benefit received. This is called the "High Income Child Benefit Charge".

If your income reaches £60,000 then Child Benefit is recovered in full by the High Income Child Benefit Charge. Alternatively, the claimant can disclaim Child Benefit.

Continued

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