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By Priya Kotecha*

Self-employed OR limited company?

In the last issue, we looked at the self-employed status in general and what this means for your tax position (*Vital* winter 2012 pages 20-21). In this issue, we consider the use of limited companies.

Firstly, let's get some of the jargon out of the way before I get too carried away with myself and go into my own happy little world of accountancy where only I know what I am talking about...

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Incorporating – the process of forming a limited company
Companies House – the body that holds information about your company and where you have to submit accounts and returns
Director – the person or persons appointed by the shareholders to safeguard the company and steer it in the right direction
Shareholders – the parties holding shares in the company. Each share is essentially a little part of the company so if someone owns 100% of the shares, it means that they own 100% of the company. (Note – in small limited companies, the director and the shareholder are often the same person).

When writing this article, I am assuming that you, the lovely reader, do not know anything about limited companies. If that is not the case and you know a fair bit – I am sorry to be patronising you and by all means, feel free to pick up the phone and give me a call to discuss the more intricate details of companies. You will make my day.

A limited company is a separate body in the eyes of the law, even if you own 100% of the shares. So, if you form a limited company and own 100% of the shares – you can still sue the company and the company can sue you! This is very important because it means that you must be very careful when taking any monies out from a limited company. If you incorporate, you cannot treat the company bank account as your own bank account – even if you operate it and own the company outright by virtue of owning 100% of the share capital. You can only take legal dividends (we will talk more about this later) and salary payments (the latter of which must have been processed via payroll out of the company account). The dividends can be paid to you as a shareholder as a means of distributing profit from the company – much like how you might receive dividends from your shareholding in Marks and Spencer. The salary can be paid to you because the company employs you as a director. So you essentially have two roles.

In fact, the Marks and Spencer example is a good one (even if I say so myself) because it demonstrates some of the fundamental points of a limited company which people forming small companies often overlook because it is 'just them'.

So, if you have shares in Marks and Sparks, it means you own a little part of it. If all the shareholders got together – they all own Marks and Spencer jointly between them. So does this mean you can nip behind the till when you are at the shops because you are a little short of cash for the weekly shop and help yourself? No! The same thing applies when it is your own company – you can only take correctly authorised payments out of the company.

What if you don't have enough money in your account to pay your TV licence? Can you ask the TV licence people to collect it from Messrs Marks' account? No. Likewise, you cannot use your company account to pay for any of your personal expenses – only expenses of the company incurred in the course of its trade.

So let's consider a few key points if you are thinking of forming a limited company:

1. It is only possible to incorporate if you are currently self-employed and you have checked with the relevant associations that you are permitted to do so
2. You must formally register your company and then file company returns and accounts with Companies House within the specified periods
3. Your company must receive its income into its own company account and pay for all its expenses via its company account. If you currently have a contract of service with, say, a dental practice, this will need to be replaced by a contract between the practice and the company. The practice will then pay the company and the company will pay you
4. The company may pay you dividends if it has surplus profits left over after accounting for its own tax liability as it must pay corporation tax on its profits. These dividends must be correctly recorded and planned for. Your accountant will help you with this
5. If the company pays you a salary it must be routed via a payroll scheme with tax and National Insurance, if applicable, being deducted by the company and paid to HMRC before it pays you
6. You must submit a personal income tax return on which you should state your employment income from the company as well as the dividends you have received from the company because there may well be additional tax to pay on this. The company will submit its own company tax return.

Ah. You may have spotted a problem. So, the company has already paid tax and then you have to pay tax again? Isn't that paying tax twice? Well, it can be. It all depends on the figures we are looking at. Let's consider the example of Kate Middleton – a dental hygienist who has checked and confirmed that she can operate via a limited company. She is currently self-employed.

Self-employed

Income: £60,000
Expenses: (£10,000)
Profit: £50,000
Personal allowance: (£8,105) this is tax free
Taxable: £41,895
£34,370 taxed at 20% = £6,874
£7,525 taxed at 40% = £3,010
Total income tax = £9,884
Class 2 National Insurance = £137.80
Class 4 National Insurance = £847
Total tax and NIC = £10,868.80

Company route receiving a salary of £7,400

Company:
Income: £60,000
Expenses: (£10,000)
Salary: (£7,400)
Profit: £42,600
(Note – no personal allowance as the company isn't a person!)
Corporation tax - £8,520
Available to pay dividends - £34,080

Kate:

Salary - £7,400
Balance as a dividend - £34,080
Income tax on dividend – '0' on this amount. A higher dividend would trigger a tax liability as would a situation where Ms Middleton had other income say from an employment somewhere or from renting a property out.
No income tax or National Insurance.
Total income tax and corporation tax = £8,520

So you can see that Kate has, in this situation, saved around £2,348 by operating a limited company. It won't always be this way however – it varies wildly from situation to situation and that is why it is so important to make sure you sit down with your accountant before you do anything to weigh up the potential tax savings (if any) against the potential additional costs as there is a lot more admin and there are more responsibilities. Some expenses also may get relief to a different degree, such as your car expenses, and so this also needs to be factored in.

Some potential downsides with incorporation may include:

1. Your practice not liking it
2. You losing flexibility
3. Not being able to keep on top of the additional requirements for statutory accounts and returns with hefty fines for late or non-compliance
4. Not being able to get used to the different way of operating. It is a complete change and one that is often hard to manage when you have been doing things a certain way for many years and have just got used to juggling it with your other responsibilities in life!
5. Tax savings reducing, minimising or going negative if your situation changes
6. Costs of incorporation reducing tax savings to nothing
7. Invasion of privacy. Your company accounts will be available for any member of the public to obtain a copy of and view in return for a nominal fee!

'It is only possible to incorporate if you are currently self-employed and you have checked with the relevant associations that you are permitted to do so.'

Even if you do not incorporate, it is worth at least thinking about it. Review your other options as well – it may well be that you can make tax savings to the same or greater degree by just rearranging your affairs slightly. Speak to your accountant about it. We don't bite and some of us are actually quite nice.

What is the legal position on hygienists incorporating?

According to Section 43 of the Dentists Act 1984, anyone can be a shareholder in a company providing hygienist services but a majority of directors (or the only director if there is just one) must be a dentist or a registered dental care professional (DCP).