GARBETTS g
Chartered Certified Accountants

HOW THE COMPANY AND CONTRACTOR ARE TAXED

Company taxation is complicated, and more so in the post IR35 environment than ever before, but the main taxes are:

1. PAYE Income Tax and National Insurance, deducted from salaries paid to the director(s), company secretary and any other staff - under the IR35 rules the main earners salary is set at a minimum level.

2. Corporation Tax paid on company profits. The profits are after deduction of directors/secretary's salaries . Dividends are paid out of profits after Corporation Tax and carry a personal tax credit for Corporation Tax paid.

3. Value Added Tax.

The split between Income Tax/NI and Corporation Tax is dependent on whether you take money out of the company by dividends or salary, and in turn this affects the directors personal tax situation and IR35 issues. For a PSC the company income is the "wages" earned by the contractor himself, and therefore the important thing is to minimise the overall tax burden paid to the government.

<u>Dividend or salary</u>

The contractor working through his own company will have a choice of taking money out of the company by salary, which is a reward for his work, or dividends on his shares, which is a reward for his investment in the company.

A salary is subject to Income Tax and National Insurance, a dividend just Income Tax, so all other things being equal it is better to have a high dividend and low salary to minimise National Insurance costs - this is where most of the savings through having a company will be made. However a low salary does restrict the amount which can be paid into a pension scheme. Where contracts are caught by IR35 a minimum percentage of the contract revenue must be paid as salary.

<u>PAYE</u>

PAYE stands for Pay As You Earn, and is the system which employers (ie your PSC) are forced to operate to collect Income Tax and National Insurance from employees (ie you as a director). These notes assume that you as director are the only company employee, although they would also apply to your company secretary if he or she is paid and any other paid staff.

Under PAYE Income Tax is calculated by reference to your earnings, less a tax free amount determined by your tax code. Earnings over the tax code are taxed at 20%, or 40% as appropriate. The earnings and tax are then carried forward to your summary position for the year.

There are two types of National Insurance payable. Employees NI is deductible from your salary, and Employers NI is payable by the company on your salary; of course as its all your money in the first place the difference is academic.

Tax and NI rates are set out in a separate document in this section.

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Corporation Tax

The company pays Corporation Tax on its profits. Basically profits are income, less expenses, less directors (and other) salaries. Rates are set out in a separate document in this section.

The main rate of Corporation Tax is 21%; this applies to profits up to £300k pa.

Corporation tax is payable nine months after the end of the company's tax year, under CTSA (Corporation Tax Self Assessment).

Dividends are paid out of the company's profits after corporation tax, and carry a 10% tax credit which is deemed to cover personal Income Tax liabilities at basic and lower rates - i.e. the tax credit covers the personal 20% liability. Where the individual is liable at Higher Rates, normally 40%, a special rate of personal Income Tax at 32½% applies, equal to 22½% once the tax credit is taken off – this equalises the effect of the 10% tax credit for a Higher Rate taxpayer.

EG 1: If a company's profits before tax were £20,000, Corporation Tax would be £4,000 (minimum 20% applying), leaving a maximum of £16,000 for dividends (you can draw less). If the maximum is drawn then the dividend will carry a tax credit of £1,777, and will be treated as equivalent to gross income of £17,777 for the shareholder with lower and basic rate tax paid.

EG 2: Continuing from EG1. If the recipient of the £17,777 net dividend was a Higher Rate Tax payer then any higher rate tax would be at 32½% rather than the normal 40% - this works with the lower tax credit to charge an effective 40%:

£	
Dividend	16,000
Tax credit	1,777
Gross income	17,777
Higher rate tax at 32½%	5,777
Less tax credit	1,777
Higher Rate tax due	4,000
Net cash for shareholder	12,000

Previously when tax credit was given at 20%, on a net dividend of £16,000 tax credit would have been £4,000, making gross income of £20,000. Higher Rate tax at 40% would have been £8,000, less £4,000 tax credit, leaving £4,000 personal tax payable and £12,000 net cash for the shareholder, the same as above.

HOW THE COMPANY AND CONTRACTOR ARE TAXED continued

Personal Income Tax

For any given tax year, your salary and dividends from the company and any other income such as rent received, investment income or pension income will be aggregated via your Self Assessment Tax Return and the net amount will be subject to Income Tax at the following rates (2010/11):

Income band	Tax %
£0-£6,475	0%
£6,475-£43,875	20%
£43,875 - £156,475	40%
over £156475	50%

NB abatement of personal allowances takes place at £100,000

Tax paid under PAYE or tax credits on dividends are set off against the overall liability.

To the extent that dividend income falls into the 20% band, it is taxed at 10%, and covered by the Corporation Tax credit. To the extent that dividend income falls into the 40% band the credit is 10% and there is a further 22½% liability (32½% charge less 10% credit) - this neutralises the effect of the Corporation Tax rate being 21% but the tax credit rate only 10% - similar considerations apply to the 50% band.

VAT

VAT is a completely different tax, based on transactions rather than profits/income.

Full details are in the separate “VAT for PSCs” section in this area of our www site.

HOW THE COMPANY AND CONTRACTOR ARE TAXED ***continued***

When is tax due?

PAYE/NI	Normally calculated quarterly to 5/4, 5/7, 5/10, 5/1 (although in practice to 30/3, 30/6, etc, is not a problem) and due by 19th day of month after quarter end, i.e. 19/4, 19/7, etc.
	Some contractors prefer to leave payment of their PAYE/NI till the end of the tax year, i..e 19th April annually. From April 2010 this is not permissible, and will give rise to penalties. Payment must be made monthly, or quarterly if payments are less than £1,500 p/m
Corporation Tax	Corporation Tax is calculated when the year end accounts are prepared and is due 9 months and one day after the year end. For 31 March year ends the payment date is 1 January the next year.
Higher Rate Income Tax:	Due under the Self Assessment regime on 31 January after the tax year, i.e. 31 January 2011 for the 2009/10 tax year ending 5 April 2010.
	There may be payments on account due for a tax year if your Income Tax, after deduction of tax at source, exceeds a trigger limit for the previous year. For 2009/10 payments on account would be based on the 2008/09 tax liability and would be due on 31 January 2010 and 31 July 2010 with the balance due on 31 January 2011. On 31 January 2011 you may also have to make a payment on account for 2010/11 as well, etc.

Interest is normally charged on overdue tax payments, although small interest charges are not pursued by HMRC. Interest rates are in line with bank borrowing rates and are not onerous. Personal Income Tax liabilities due under Self Assessment are subject to a 5% surcharge if paid more that 30 days late.

VAT is due on a quarterly basis, payable 30 days after the quarter end. We normally arrange for the quarter end to tie in with the PAYE quarters. There is an onerous penalty regime for late VAT payments, although in many cases PSC will fall under de-minimus levels for the lower end penalties.

Arnold House 2 New Road Brading Isle of Wight PO36 0DT Telephone 01983 400350 Facsimile 01983 404016 E-Mail: office@garbetts.com www.garbetts.com

Garbetts Limited Chartered Certified Accountants and Registered Auditor Registered in England Number 2988424 Director: Paul R Garbett FCCA
Part of Garbetts Group Limited Registered in England Number 2886513 Directors: Paul R Garbett FCCA, Robert Garbett, Sandra Garbett BA (Hons) Law