

SHOULD YOU INCORPORATE YOUR PRACTICE?

The amendments to the Dentist Act came into being in July 2006, and allows dentists operating as sole traders or partnerships to incorporate as a limited company.

Read on for a brief overview of the advantages and disadvantages of incorporating.

Dentists in higher income tax bracket

Consider Bob's situation. He operates as a sole trader and pays income tax at the higher rate of 40%. Bob anticipates his practice profit to be in the region of £120, 000 for the year ending 31st March 2004 and wonder whether it'll be advantageous to incorporate his practice as a limited company.

What are the advantages?

The main advantage for Bob is the possibility of saving his annual tax bill. Being higher rate tax payer the Bob's potential savings can be illustrated below.

On an expected profit of £120,000 Bob will have to pay the following income tax and Class IV NI contributions for the income tax year 2004-05.

Class IV NI contributions		
	£	£
Total taxable profit for the year 2004-05 after adjustments*	120,000	
Less: Lower earnings limit	(4, 745)	
	115,255	
Class IV NIC at 8% on	26,975	2,158.00
Class IV NIC at 1% on	88,280	882.80
Total Class IV NIC		3,040.80

*Profit after adjusting for non tax deductible expenses such as depreciation etc. Also this has ignored income from other sources.

Income Tax Liability		
	£	£
Total taxable profit for the year 2004-05 after adjustments*	120,000	
Less: Allowances		
Personal allowance 2004-05	(4,745)	
	115,255	
Tax Borne		
2,020 @ 10% starting rate		202.00
29,380 @ 22% basic rate		6,463.60
83,855 @ 40% higher rate		33,542.00
Total income tax liability		40,207.60

Total Class IV NIC		3,040.80
Total Class II NIC (52 weeks @ £2.05 per week)		106.60
Total Class II, Class IV NIC and Income Tax Liability		43,355.00

Can Bob save his total tax liability by incorporating his dental practice?

In light of the above tax bill, Bob wishes to know whether he can save his tax bill by incorporating his dental practice.

The answer to this is it depends!

It depends on how he wants to be remunerated. When Bob incorporates his practice he'll become an employee of the company, perhaps a director. In this situation company can remunerate him in three ways.

Depending on the method, the potential savings can differ. First, let's identify the three remuneration methods available.

A) Salary Route

The new incorporated entity can remunerate Bob, the sole share holder, by way of salary not exceeding £120,000 – the available profit. However, the company should be mindful that it has an additional liability in the form of employer's NI contributions on Bob's salary. There won't be any corporation tax since total profit will be paid out to Bob as a salary.

B) Dividend Route

The new incorporated entity can remunerate Bob, the sole share holder, by way of an annual dividend. Here, the profit available for dividends will be reduced by the corporation tax on the taxable profit of £120,000.

The profit after corporation tax will be paid to Bob as a dividend.

B) Salary and Dividend Route

The salary and dividend route will first utilise Bob's annual personal allowance of £4,745 by paying him a salary of £4,745, per annum which is tax free. Then the remaining profits will be subject to corporation tax. Then, the remainder will be paid to Bob as an annual dividend

The three routes are illustrated in the following table.

	Limited Company		
	Salary Route	Dividend Route	Salary and Dividend
Profit	120,000.00	120,000.00	120,000.00
Salary	106,921.42		4,745.00
Employers NI	13,078.58		4,745.00
Liabe to Corporation Tax			115,255.00
Corporation Tax		22,800.00	21,898.45
Profit After Tax but Pre Dividends		97,200.00	93,356.55
Additional Tax Payable			
Total Tax Bill (Memo only)		22,800.00	21,898.45
Available for dividend		97,200.00	93,356.55
Dividend (net)		97,200.00	93,356.55
Salary	106,921.42		4,745.00
Tax	34,976.17	16,167.38	16,274.14
Class 4 NI			
Class 2 NI			
Employees NI	3,719.26		
Total Deductions	38,695.43	16,167.38	16,274.14
Net Disposable Income	68,225.99	81,032.63	81,827.41
Saving/(Cost) compared to the Salary Route		12,806.64	13,601.43
Saving by using Salary/Dividend			13,601.43

Potential Savings

The potential savings of each of these routes are compared with Bob's overall tax position when operating as a sole trader.

Remuneration Method	A	B	C
Corporation tax liability	Nil	22,800	21,898.45
Employer's NI contributions	13,078.58	Nil	Nil
Income tax	34,976.17	16,167.38	16,274.14
Employee's NI contributions	3,719.26	Nil	Nil
Total Tax and NI contributions – Ltd Co.	51,774.01	38,967.38	38,172.59
Total Tax and NI contributions – Sole trader	43,355.00	43,355.00	43,355.00
Saving	(8,419.01)	4,387.62	5,182.41

The above illustration reveals that Bob can potentially save approximately £5,000 per annum by incorporating his dental practice and electing to remunerate himself through "salary and dividend route". The only situation where he will pay more tax is by electing to remunerate him through "salary route".

Therefore in summary, Bob being a higher rate income tax payer can potentially save around £5,000 per annum on a forecasted taxable profit of £120,000.

The other advantages of incorporation include,

- The money paid for goodwill on acquiring your practice will be tax deductible. Since most dentist pay income tax at 40% this can potentially save 40% of the money you have paid goodwill on acquiring the practice.
- In selling the practice the liabilities will pass to the new owners together with the assets.
- In the eyes of law incorporated entity will have a separate identity, thus owner's liability will be limited.

The associated costs and disadvantages

You should be mindful of the following costs and disadvantages,

- Initial incorporation costs which are a one off expenditure.
- Additional paperwork and administration work such as submission of annual accounts to the Companies House, correspondence with the companies house, directors tax, corporation tax, company AGMs to declare dividends and the maintenance of minutes etc.
- Most of the above administration and paper work will be handled by your accountant. The additional cost for this will be in the region of £100 per month.

What's the situation if Bob is in a lower income Bracket?

From the following illustration you can see that bob can still save some tax money, though it's obviously less than when he was in a higher income tax bracket.

	Individual	Limited Company		
		Salary Route	Dividend Route	Salary and Dividend
Profit	25,000.00	25,000.00	25,000.00	25,000.00
Salary		22,701.56		4,745.00
Employers NI		2,298.44	25,000.00	4,745.00
Liabe to Corporation Tax				20,255.00
Corporation Tax			3,562.50	2,435.56
Profit After Tax but Pre Dividends			21,437.50	17,819.44
Additional Tax Payable			972.11	1,161.95
Total Tax Bill (Memo only)			4,534.61	3,597.51
Available for dividend			20,465.39	16,657.49
Dividend (net)			20,465.39	16,657.49
Salary		22,701.56		4,745.00
Tax	4,213.70	3,708.04		
Class 4 NI	1,620.40			
Class 2 NI	106.60			
Employees NI		1,975.22		
Total Deductions	5,940.70	5,683.26		
Net Disposable Income	19,059.30	17,018.30	20,465.39	21,402.49
Saving/(Cost) compared to the Salary Route			3,447.10	4,384.20
Saving/(Cost) compared to the Individual Route		(2,041.00)	1,406.09	2,343.19

Conclusion

Provided you are a dentist in the higher income tax bracket, you can have significant tax savings as illustrated above. The downside to incorporation is the initial set up costs, the procedures and paperwork involved on ongoing basis, though this will be handled by your accountant for an additional fee. Also, your summarised financial information will be available to the public at the Companies House. Further, it necessitates you improve your record keeping habits!

Before, coming to a conclusion you should consult your Accountant to discuss your particular circumstances and concerns since depending on individual circumstances the costs might outweigh the benefits and vice versa. However, in general higher the taxable profit it's more advantageous to incorporate in light of significant tax savings in the long run.