A lot of the confusion and ill-informed comment surrounding the issue of incorporation is centred on the question of tax – how much you may have to pay to incorporate and whether your overall tax liability will be higher or lower after your practice becomes a limited company.

In this article, which sometimes refers to matters already considered in previous articles, analyses in more detail the differences between your liabilities as a sole trader or partnership and your practice’s liabilities after incorporation.

Types of tax

There are four principal categories of tax to consider when comparing the fiscal liabilities of a sole trader to those of a limited company. Practice partnerships, although they may be legal entities, are not subject to tax; for tax purposes each partner is effectively a sole trader, whose tax liabilities are assessed via his or her personal tax return according to their share of the practice’s profits.

The taxes we need to consider are:

- Income-Tax (and National Insurance)
- Corporation Tax
- Capital Gains Tax
- Inheritance Tax

Our figures will assume that the dentist(s) has no other taxable income, and are based on the Inland Revenue’s tax tables for 2009/2010. We’ll look first at the situation of the sole trader, the dentist who is running their practice as a self-employed person with their own business.

A sole trader pays Income Tax and National Insurance (NI) on all of the business’s profit, which is seen as his/her income in any given year, whether or not the profits are withdrawn from the business. The rate of taxation varies according to the amount of profit, with no tax or NI paid on roughly the first £5,000, a total of 20 per cent being paid on roughly the next £37,000 and about 41 per cent thereafter, so the threshold for tax purposes each partner is effectively a sole trader, whose tax liabilities are assessed via his or her personal tax return according to their share of the practice’s profits.

Sole traders do not pay corporation tax.

If the sole trader sells their practice to a limited company in which he/she has an interest, or to any one else, Capi- tal Gains Tax is payable on the profit on the sale. The rate of Capital Gains Tax is 10 per cent on the first £1,000,000 per taxpayer, per lifetime, and 18 per cent thereafter.

A dental practice owned by a sole trader qualifies for Business Property Relief, and no Inheritance Tax is payable on the value of the practice on death.

Limited companies pay Corporation Tax instead of Income Tax on any profits or capital gains. Provided the dentist controls only one limited company, the rate of Corporation Tax is 21 per cent on the first £300,000, 25.75 per cent on the next £1,200,000 and 28 per cent on profits above £1,500,000.

With a few exceptions (for example, private motor vehicle expenses), the company’s profit subject to tax is calculated in the same way as for a sole trader. A salary paid to the dentist as a company director or as an employee is a tax-deductible expense.

Dividends, being the distribution of after-tax profits to the shareholder(s), are not tax deductible.

Any salary drawn from the limited company by the dentist as a director is subject to personal Income Tax and NI as described above, except that the middle band rate (between about £6,000 and about £57,000) is 51 per cent. If the dentist is paid more than £5,175 per year as salary, the company also has to pay NI, at 12.8 per cent on the excess.

Dividends paid to the dentist as a shareholder may be subject to Income Tax but not to NI. If the dentist’s total income including dividends is less than £45,875, the dividend tax rate is zero per cent. If total income exceeds this figure, excess dividends above this level are taxed at 25 per cent. Any salary paid to the dentist paid would therefore reduce the amount of dividend, which qualified for the zero per cent rate of tax.

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Tax liabilities

Dentists should not forget that, although the practice may be the company’s sole asset, the company and the individual are separate entities, and any Capital Gain that results from the company ultimately selling the practice or any part of it to a third party will be included in the company’s profits and liable to Corporation Tax. However, it is usually more beneficial for the individual to ultimately sell their shares in a limited company to a third party, as the gain here will be taxed at the personal Capital Gains Tax rate of 10 per cent or 18 per cent, rather than the higher Corporation Tax rates.

The shares in a ‘close company’, such as a family owned dental practice, qualify for Business Property Relief, and no Inheritance Tax is payable on the death of an active shareholder.

Many dentists operating as sole traders will have broadly similar financial circumstances, but there will always be factors peculiar to individual situations.

Although incorporation very often brings significant benefits, it is not a ‘one size fits all’ solution and expert advice should always be sought before any decision is taken.

To receive hard copies of earlier articles in our series, please email your name and address to rae@lansdellrose.co.uk.

About the author

Michael Lansdell was brought up in South Africa, receiving his honours degree there in 1981. He completed his training with international accounting firm Deloitte in 1994, and went on to become a founding partner at Lansdell & Rose Chartered Accountants (SA) a year later. Based in Kensington, London, Lansdell & Rose deal exclusively in the incorporation of dental practices. As a client-focused team, they look to achieve sustainable long-term solutions for their clients that maximise profits, minimise tax and build wealth. For more information, visit www.lansdellrose.co.uk or call 020 7376 9333.