What constitutes profit for tax purposes?

As is nearly always the case where tax is involved - there is no simple answer. Self-employed business owners' profits are subject to income tax and National Insurance – and limited companies to corporation tax. However, before making this distinction it is important to state that profit shown on your accounts is not the figure used by HMRC to work out taxes due. Your published figures are adjusted to reflect depreciation of assets (which is added back and replaced with a capital allowance) and allowable business expenses such as equipment and supplies, utility bills, etc - see www.gov.uk for the full listing.

Payments to the owners of the business are treated differently if the business is incorporated or self-employed. Some of these distinctions are:

Self-employed – income tax and Class 4 NIC

Sole traders and partners in trading partnerships (including Limited Liability Partnerships) are subject to income tax and Class 4 NIC. Profits adjusted for tax purposes are treated as the income of the business owner.

The self-employed are not taxed on the funds they withdraw from the business but the profits they earn. They will pay income tax at 20%, 40% or 45% depending on the amount of profits earned. Additionally, the self-employed pay Class 4 NIC of 9% on profits between £8,632 and £50,000. This 9% rate drops to 2% for profits earned in excess of £50,000.

This exposure to potentially high rates of income tax and NIC is the main reason for considering the incorporation of successful self-employed business.

Limited companies

In the majority of cases limited companies pay corporation tax on their adjusted trading profits at a fixed rate. Currently, corporation tax is charged at 19%.

However, if directors/shareholders withdraw money from the company they are taxed separately on those withdrawals. The most common director shareholder rewards are:

•A salary – taxed under the PAYE rules. Salaries and employer NIC charges are an allowable deduction for corporation tax purposes.

•A dividend – dividends are a distribution of taxed profits (company trading profits less corporation tax paid). They are not a cost to the business and do not reduce the company's

corporation tax bill. Any dividends received by shareholders in excess of £2,000 are taxed at hybrid rates of income tax (7.5%, 32.5% or 38.1%) the rate you would pay depends on the level of your overall income.
•A benefit, company car etc – most benefits are treated as income and will increase a beneficiary's income tax charge. Additionally, companies will be charged extra NIC based on the total value of benefits provided.

Working out the best structure for your business should take these distinctions into account. However, there are a range of other "risk" considerations that should be examined. We would advise that you speak to your accountant if you are concerned that you may not be operating in the most tax efficient way.

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