

Budget 2009



Professional service firms – a Budget change?

The introduction of the additional higher rate of tax of 50 per cent with effect from 6 April 2010 may challenge firms to improve their overall tax efficiency.

For professional service firms which traditionally draw out all of the profits of the business, there has been a significant tax advantage in operating through a tax transparent structure (such as a partnership or LLP) as opposed to a company. Even with headline rates of 50 per cent there is still a tax saving (approximately 5.5 per cent compared to drawing salary) of using a partnership or LLP as highlighted in the table below, although the margins are decreasing.

Individual taxpayer top tax rate 50%	Effective rate 2008/09 and 2009/10	Effective rate 2010/11	Effective rate 2011/12
Dividend			
Small company	40.75%	49.53%	49.53%
Marginal rate company	47.31%	55.12%	55.12%
Large company	46.00%	54.00%	54.00%
Remuneration	47.70%	56.57%	57.19%
LLP or partnership (ignoring tax on disallowables)	41.00%	51.00%	51.50%

These figures are based on the following assumptions:

- The individual is a higher rate taxpayer and pays maximum National Insurance Contributions.
- The small company rate of tax remains unchanged at 21 per cent throughout.

Whilst the above table highlights the effective tax rates on the extraction of profits a much larger tax differential can be seen between the rates applicable to capital gains as opposed to income – 18 per cent compared to 50 per cent. Traditionally, professional service firms have operated by allowing partners to draw out all profits and thus on retirement partners have tended not to receive a capital distribution based on the increase in the value of the business over their term as a partner. For firms seeking to minimise partners overall exposure to tax this model may need updating to enable capital value to build in the business and be taxed under the more favourable capital gains tax (CGT) regime.

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Seeking to retain value within the business is at odds with a full distribution policy and therefore thought should also be given as to whether a corporate structure with its lower rates of tax on retained profits is now more advantageous.

What else can be done to minimise the 50 per cent tax rate

Firms with accounting year ends falling early in the tax year should consider a change to one later in the tax year 2009/10 in order to maximise profits being taxed before the 50 per cent tax rate is operational.

For example, if a firm with a 30 April 2010 year end were to move this forward by 1 month to 31 March 2010, 11 months of profit which would have been taxed in 2010/11 will now fall to be taxed in 2009/10 at 40 per cent, rather than 50 per cent. This will also cause the tax to become payable at an earlier date and there are conditions which prevent a further change of year end in the next five years. The funding cost and impact on cash flow need careful consideration to ensure that the overall effect is favourable.

Tax savings can also be achieved by using a company to supply services to a partnership or LLP. Typically the company employs staff and charges a fee to the partnership for supplying their services. The fee must be calculated in accordance with UK

transfer pricing rules and this gives rise to the profit in the company being taxed at corporation tax rates but without the need to retain those profits. The tax saving (assuming the additional rate of 50 per cent would otherwise apply) is between 21 per cent and 30 per cent.

The above tax planning ideas are not without risk and it is expected that HM Revenue & Customs will look to bring in anti-avoidance legislation to try to prevent individuals circumnavigating the 50 per cent tax rate. We would also be wary of making drastic changes which may not be favourable if the tax rates were to come down in the near future. However, we would strongly urge all professional service firms to start considering now the action that they may take to help mitigate the additional tax rate from 6 April 2010. We would be delighted to meet with you to discuss our ideas for your firm.

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As with any tax planning strategies, trusted professional advice should be taken before any action is taken.

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