STARTING A PRIVATE PRACTICE

Estimating how much to save for the taxman

Specialists often find managing their business drawings and saving for tax one of the biggest headaches when they are starting up. **Ian Tongue** gives some sound advice and tips to help

DOCTORS STARTING out in private practice typically ask their accountants two big questions:

1. 'How much can I take from the business?'

2. 'How much tax do I need to save?'

These are two very important questions to be asked if you want to avoid being caught out later on. However, the answer to both will depend on your individual circumstances.

A number of factors affect the available 'drawings' a doctor might have. For instance:

- Trading structure;
- The new 50% tax rate and loss of personal allowances;
- The self-assessment payment on account system;
- Other income sources;
- Pension changes.

> "It would be normal to deduct 20-25% from income for expenses, with the resulting net profit usually being a reasonable estimate of taxable profit"

Trading structure

This is a very important consideration, as the type of structure used may result in the overall tax liability being spread over several headings of tax which are calculated and paid on different dates and at differing rates.

For example, a company is liable to corporation tax, while any dividends received by you will be subject to income tax.

Sole trader

As all income is taxed in the year earned, this is usually an easier structure to calculate the tax and National Insurance due and, therefore, to save for and ultimately determine how much can be spent.

However, the introduction of the 50% income tax band and loss of personal allowances in the UK tax system has made this more complicated.

The vast majority of consultants engaging in private practice will retain their NHS position either wholly or in part. This status is very important in determining how much to save and indeed often forms part of the decision on which trading structure is most appropriate.

With additional work, most NHS consultants will earn more than their basic salary, pushing them to at least £100k taxable salary or significantly more. The effective income tax – including National Insurance – rates are shown in the box on the right, effective from 6 April 2010.

The basic rate tax band has been ignored on the assumption that a salary of at least £43,876 is received.

As a rule of thumb, it would be normal to deduct 20-25% from income for expenses, with the resulting net profit usually being a reasonable estimate of taxable profit.

Using the table should enable you to work out how much over and above your salaried earnings will be taxed, and enable you to save for income tax and National Insurance.

> "Using the table should enable you to work out how much over and above your salaried earnings will be taxed"

WHAT YOU PAY THE TAXMAN FROM YOUR PROFITS

(Income tax and NI)

Earnings between:

£43,876 up to £100,000 –	41%
£100,001 and £112,950 –	61%
(due to the withdraw of personal allowances)	
£112,951 and £150,000 –	41%
Over £150,000 –	51%

When looking at the estimate of your expenditure it is important to consider your individual circumstances.

Many consultants use the services of the private hospital for administration and receive a net income for this and therefore their other costs would be lower.

Additionally, factors such as the amount of indemnified work being performed are important, as again your cost base will be lower. Your accountant should be able to assist you with assessing your individual circumstances.

Assuming 25% tax-allowable expenditure and a taxable NHS salary of £100,000, a private practice with a taxable profit of £50,000 (income circa £67K), would equate to approximately a 46% effective tax rate on profits or 35% of income.

Extending this to £100,000 taxable private practice profit (income circa £133k), the effective tax rate on profits would be approximately 49%, which represents approximately 36% of income.

Subject to any capital needs for the business, the majority after saving for tax should be available as your business drawings.

Partnership

If you are in partnership with your spouse, the above principles apply, however the profits must be split between the partners before applying the tax rates.

If the partner is a basic rate taxpayer, they must broadly save 28% for income tax and National Insurance after their personal allowances.

Discussing this with your accountant should avoid any nasty surprises in this area, as usually liabilities can be forecast in advance – particularly useful if you have just changed to this structure.

Limited company

A limited company pays tax in its own right known as corporation tax. For small companies, corporation tax (up to £300k profits) is currently 21%, which is reducing to 20% from 1 April 2011.

Profits in excess of £300K up to £1.5m are taxed at an effective marginal rate of tax of 29.75% up to 31 March 2011. The rate for profits in excess of £1.5m is 28%.

Therefore, you will need to estimate your taxable profit within the company and save for corporation tax within the company itself at the appropriate rate.

The most common method of extracting profit from the company is to pay a dividend to its shareholders. The receipt of a dividend is subject to income tax. However, the amount will depend on your tax position, including all sources of income.

Frequently, the shareholders have differing tax positions and therefore how much to save will depend on whether the shareholder is a basic rate taxpayer, higher rate taxpayer or subject to the new additional rate.

The following table indicates the amount which must be saved for income tax based on total income level:

- £0-£43,875 – No additional income tax to be saved;
- £43,875-£150,000 – 25% of dividend received;
- Over £150,000 – 36.11% of dividend received.

The balance after saving for tax is usually available to spend. It is worth noting that the concept of 'drawings' does not apply to a limited company and therefore the usual ways of extracting profit from a company are via salary and dividends.

Self-assessment

The self-assessment system for individuals requires a payment on account to be made during the year being taxed (31 January payment) and just after the tax year finishes (31 July payment) and therefore it is vital that you are saving for tax as soon as you are earning money to avoid being caught out later on.

Companies usually pay tax nine months and a day after their accounting year end in arrears, again under a self-assessment system. Companies earning in excess of £1.5m must pay in instalments.

Other income sources

An individual could have many sources of income in addition to their salary and private practice. These income sources are usually treated slightly differently to each other and there is an order in which they are taxed.

If you have multiple sources of income, it is important that you discuss your tax-saving requirements with your accountant to allow you to determine how much money is disposable.

Pension changes

There are discussions in place to restrict the level of tax relief available on pension contributions. The previous government was seeking to apply a restriction to those earning in excess of £150,000, but the coalition Government is looking at a maximum level of contributions approach rather than linking to income level.

These measures are under review by ex-Labour cabinet minister John Hutton and a White Paper is due later this year. No doubt this will include proposals that will affect the level of tax which must be saved for certain individuals.

This could particularly affect those who make large payments in personal pensions or have high NHS salaries. Once these measures are announced, it is important that you discuss your individual circumstances further with your accountant.

The above assumes a low level of financial complexity of affairs and ignores the many permutations of situations that an individual may face specific to their circumstances.

Discussing your individual circumstances further with your accountant should enable you to adequately save for tax and determine how much disposable income is available.

■ **Next month: Managing bad debts**

Ian Tongue is a partner at Sandison Easson & Co, specialist medical chartered accountants