What is Corporation Tax?

Corporation tax (CT) is the tax payable on the taxable profits generated by a limited company. A public limited company (PLC) and a business based overseas but with a permanent UK establishment will also pay the tax, which is collected by HMRC.

Many UK-based small to medium sized enterprises (SMEs), contractors and freelancers trade via a limited company. Therefore, an understanding of corporation tax is essential, as failure to calculate tax accurately, complete and submit a corporation tax **self assessment tax return** and pay any tax due on time could lead to penalties and even prosecution.

Although corporation tax is generally associated with limited companies, it is also paid by clubs, societies, associations and other unincorporated bodies. However, sole traders and partnerships do not pay corporation tax – the proprietors and partners of these types of business pay income tax on their share of any profits.

A video produced by the Government provides a useful introduction to corporation tax and how it works. **View here.**

UK corporation tax rates

UK corporation tax rates are among the lowest in the world and, particularly for larger companies, have been steadily decreasing. They are generally reviewed once a year during the Chancellor of the Exchequer's annual Budget in March, and could change. The rates from 1 April 2014 are:

The small profits rate for companies, and unincorporated bodies such as clubs and societies, with taxable profits of less than £300,000 is 20%

The main rate for companies with taxable profits over £1.5m is 21%

There is a special calculation for companies with profits of between £300,000 and £1.5m that is known as the **marginal relief** calculation.

Most single person contractor limited companies are likely to be affected by the small profits rate. However, where two or more contractors trade through the same limited company, which is common where two spouses or partners are both contractors, taxable profits could exceed the main threshold.

Contractors can use ContractorCalculator's online interactive **corporation tax calculator** to work out how much corporation tax they should pay.

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Contractors can extract cash tax efficiently from limited companies

The main benefits of using a limited company for contractors, freelancers and other small business owners are:

Limited liability

The ability to build a brand and grow the business to perhaps eventually sell

Tax efficiency

Financial flexibility.

Also, in most cases, the company and individual will also only be taxed once.

It is considerably more tax efficient for a contractor to pay themselves a small salary below the income tax and National Insurance Contributions (NICs) thresholds, thus paying no income tax or NICs.

Rather than paying a larger salary, the remaining remuneration is taken via a **dividend**. There are no NICs to pay on dividends and no income tax up to the higher rate tax threshold. This can reduce a contractor's tax liability resulting in a net income of up to 25% greater than if they had paid themselves a salary.

However, a dividend can only be declared if there are sufficient profits and/or shareholder's funds in the company.

Tax is only paid once and surplus funds can be retained

Assuming the dividend remains below the higher rate threshold, and there are a variety of strategies contractors can adopt to facilitate this, then the company will only pay tax once and it is likely that the contractor will pay no personal tax or NICs.

Furthermore, once the tax has been paid, the funds can be retained within the business until it is needed. So, a cash reserve can be built up during times of plenty and drawn down when the business is doing less well, or when a major investment is needed into, for example, new equipment or business growth.

What are taxable profits?

Corporation tax is only paid on taxable profits. Taxable profits come from three main sources:

Trading profits arising from the company's normal operations, such as the fees a contractor may charge their client

Investment profits arising from income from interest on cash funds on deposit, investments, such as property rental income or returns from investing in financial instruments such as equities or bonds

Chargeable capital gains, such as the profits made from selling business assets such as property, fixtures and fittings, plant and machinery alongside assets such as intellectual property and trademarks.

Very simply, taxable profits are the difference between the income from the above three sources less the expenses of the company, including any tax reliefs. Corporation tax is calculated based on those taxable profits.

If the company is based in the UK, then corporation tax must be paid on all taxable profits, including any income from overseas operations.

What are tax reliefs and credits and how do they save tax?

Taxable profits are calculated by subtracting business expenses from income. So, a **contractor limited company** may generate fee income and then deduct the contractor's small salary plus the costs of running the business such as phone costs, accountant's fees and the like to give a profit.

But a company can benefit from tax reliefs and credits, which reduce the level of taxable profits and thus the amount of corporation tax to be paid. For example, a contractor's limited company can pay for a pension, and the costs of the pension are deducted from profits so reduce tax liability.

There are a huge range of other tax reliefs and credits that can be applied to reduce a tax bill. If a company makes a loss, it is possible to gain tax relief on that loss on the previous year's profits, or to apply the tax relief of the loss to future year's profits.

Marginal relief and the marginal relief fraction

Companies with taxable profits of between £300,000 and £1.5m can claim marginal relief. This relief is specifically for companies that generate taxable profits between the two main corporation tax thresholds to ensure they transition smoothly and fairly between the two rates.

Marginal relief is calculated using a complex formula and the 'marginal relief fraction'. A simple example that assumes the company has no franked investment income is:

The company's taxable profits are calculated first, and then corporation tax liability due on that amount is calculated using the main rate (ie 21% of taxable profits)

The sum calculated in A is then subtracted from £1.5m, which is the lower main corporation tax threshold

The result of B is multiplied by the marginal relief fraction for the financial year. At the time of writing this is 1/400 for the 2014-2014 tax year

The amount in step C is subtracted from the main rate corporation tax liability calculated in step A.

HMRC has an **online marginal relief calculator** to ensure the most up-to-date rates and marginal relief fractions are used.

Corporation tax returns and payment

Every company must file a corporation tax self-assessment tax return, known as a CT600. This details the income and expenditure of the company, what tax reliefs have been applied and how much corporation tax the company must pay.

A company has 12 months after the end of its financial year, or accounting period, to file the CT600, although the company must pay the tax nine months following the end of its financial year. A CT600 must be filed even if there is no tax to pay. In practice, most contractors and small businesses will use an accountant to file their company tax return.

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