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LIMITED
CHARTERED ACCOUNTANTS
AND BUSINESS ADVISERS



KEY GUIDE

Accessing your company profits

Introduction

CONSTANTLY CHANGING TAX RULES

When business owner-managers take profits from their business, it isn't surprising that they want to do so in the most efficient manner. There are various ways to do this that can minimise both tax and national insurance contributions (NICs).

Of course, tax is not the only issue. You will almost certainly need to draw a basic level of income to cover your personal requirements, regardless of the tax cost, and it will also be necessary to retain sufficient profits in the company to cover its future needs.

The tax rules are constantly changing. Just because you have drawn profits in one way in the past does not mean that this continues to be the best approach. Company tax rates have fallen considerably in recent years, but the taxation of dividends has become more punitive, with significant increases to the rates of tax on dividends and the abolition of the dividend tax credit.

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How to pay yourself a salary or bonus in the most tax-efficient way possible



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You can draw profits as dividends, which are taxed in a different way to salaries



THE FUTURE OF YOUR COMPANY

How retained profits are taxed, and how they affect later withdrawals from the company



Salary and bonuses

Directors of owner-managed or family companies often draw low levels of salary, typically between £7,500 and £9,500 a year. This is because salaries and bonuses attract NICs. Employer NICs, at the rate of 13.8%, apply once annual remuneration exceeds £8,632 (in 2019/20) and there is no upper earnings limit. Employee NICs are 12% on earnings between £8,632 and £50,000, and 2% thereafter. So, the combined NIC cost is up to 25.8%, although the employer portion can be deducted in calculating your company's taxable profits.

Planning point

It is normally advisable to draw a minimum salary so that you do not lose any entitlement to social security benefits.

It is normally advisable to draw at least a minimum salary so that you do not lose any entitlement to social security benefits. You need 35 years of contribution to qualify for the maximum state pension under the single-tier state pension scheme, which came into force on 6 April 2016.

In 2019/20, you are deemed to have made NICs once your annual earnings reach £6,136; so, taking a salary between £6,136 and £8,632 gives you the necessary pension entitlement without any NIC cost. You will need to run a Pay As You Earn (PAYE) scheme, with the associated problems of reporting payroll in real time. However, you might decide to draw a higher level of salary than this bare minimum as the following example demonstrates.

EXAMPLE Drawing salary

Mick runs a successful consultancy firm in England. The business is a limited company and he is the sole owner.

National living wage

The national living wage is around £14,950 a year for over 25s, based on a 35-hour week, and his remuneration should not be less than this if he has an employment contract with his company. He could avoid this requirement by not having an employment contract, but the additional tax cost of moving to this level of remuneration would not normally be significant because most of it would be covered by his tax-free personal allowance of £12,500 in 2019/20.

Pension contributions

A low level of remuneration might limit the amount of tax relief that he could receive on his personal pension contributions. This would not be a problem if his company makes the pension contributions on his behalf.

Mortgages

A low level of remuneration could lead to difficulties if he wants a mortgage to buy a property. However, lenders are becoming increasingly aware of how owner/managers extract profits from their companies, so this should not be quite the problem that it was a few years ago.

Personal service company (IR35) rules

If there is a chance that his company could be classified as a personal service company under the IR35 rules, he might decide to take a high level of salary to forestall HMRC taking an interest in his company. The NICs cost may be high, but it could be worthwhile to avoid the full force of the IR35 rules being applied.

Tax efficiency

If he does need a higher level of remuneration, he could take £49,500 before the higher income tax rate of 40% bites. The first £12,500 will be tax-free because of his personal allowance and the next £37,500 will be subject to the basic rate of 20%. Salaries and bonuses are taxed under PAYE, so tax and NICs will be payable straight away.

Planning point

If your husband/wife or civil partner, or another family member, has little or no income, it can be beneficial for your company to employ them as a way of extracting profits.

Employing family members

If your spouse, civil partner or another family member has little or no income, it can be beneficial for your company to employ them as a way of extracting profits. They could receive a salary of between £7,500 and £9,500 a year at little or no tax cost, with your company benefiting from tax relief at the rate of 19% on the amounts paid. A salary between £6,316 and £8,632 would mean they retain their entitlement to social security benefits without any NICs cost. If you pay more than this, the annual £3,000 employment allowance could help small companies, because the first £3,000 of employer's NIC won't be payable. The employment allowance cannot be claimed by directors who are the only employee of a company.

However, you must be able to justify the cost of the salary on commercial grounds by the work that your husband/wife, civil partner or family member carries out; otherwise it will not be deductible in calculating your company's taxable profits.

DRAWING DIVIDENDS

The main advantage of drawing profits as dividends is that no NICs are payable. Taking a dividend is normally more attractive than a salary or a bonus, regardless of your personal income tax rate or your company's corporation tax rate. Many owner-managers therefore take a small salary to use up their personal allowance and withdraw the remainder of their income as dividends.

Dividends have no effect on your company's tax position, but the recipient pays tax where dividends exceed the £2,000 tax-free allowance (2019/20), reduced from £5,000 in April 2018. Any dividend over the allowance, but within the basic rate band for income tax, will be taxed at 7.5%. Dividends falling into the higher rate bracket will be taxed at 32.5%, and at 38.1% where they fall into the additional rate tax bracket. The change in the dividend allowance means an increase in taxation for most business owners extracting profits, as the reduced tax-free allowance will only benefit those with a low level of dividend income. Despite this recent tax increase, the difference between the tax and NIC costs of drawing a salary and a dividend can be very significant, as the following demonstrates.



EXAMPLE**Additional income paid as salary or dividend**

Madeline is owner director of a recruitment agency in Wales. In 2019/20 she has taken just enough salary to use her personal allowance of £12,500, but she now wants to withdraw another £50,000 of profits from her company. If she were to take this as additional salary or bonus, the company would have no tax liability but, after income tax and NICs, she would be left with just £32,750 to spend. However, taking a dividend would leave her with £33,770 after allowing for her company's corporation tax liability and her personal liability to tax - over £1,000 extra spendable income.

There are some drawbacks to taking a dividend, in addition to those mentioned above, with regard to drawing a low salary:

- Your company can only pay a dividend if it has sufficient profits or qualifying reserves from which to pay it, even if there is ample cash in the company bank account. A salary or bonus can be paid even if the payment means that the company ends up making a loss.
- Dividends are payable in proportion to shareholdings. This would not represent a problem if you were the only shareholder, but deciding on the level of dividend payment can be more complicated where there are several shareholders. It could mean having to pay dividends to an outside investor, which you might prefer to avoid. One way to circumvent this problem would be to have more than one class of shares.
- Paying regular dividends could increase the value of any minority shareholdings in your company for capital gains tax

and inheritance tax purposes. However, this might not be too important given the potential reliefs that are available for both taxes. Having different classes of shares would also solve this problem.

- Where you have to pay higher or additional rate tax on dividends, this will not be due until 31 January following the end of the tax year. This provides a considerable delay, especially if you take your dividends early in the tax year, as you will need to plan for their future payment. If you continue to take dividends on a regular basis, the payment on accounts rules will accelerate your tax payments in future years.

Planning point

Regardless of your personal income tax rate or your company's corporation tax rate, taking a dividend is normally more attractive than taking salary or a bonus.

BENEFITS IN KIND

It generally does not make sense for your company to provide you with fringe benefits such as a company car or buying property for personal use. Although there are no employee NICs on these benefits, your company will pay NICs at the rate of 13.8% if the benefit is taxable, so it is normally preferable to take a dividend and incur the expenditure personally.

However, working out the most beneficial option is not always straightforward, and it is sometimes worthwhile taking certain types of benefits because of their special tax rules, such as a company car, a loan from your company, or occupying accommodation provided by the company.





Being provided with the benefit may be preferable where:

The benefit is exempt from tax or only results in a low tax charge

For example, the provision of one mobile phone is exempt, and there is a low tax charge for cars with a low CO₂ emission. But be warned that the company car rules constantly change. Increases in the appropriate percentage of list price for cars have been imposed each year for several years up to 2019/20.

Having the benefit avoids higher rates of tax

With a high value item such as a house, you would have to take out a large dividend to cover the purchase cost. This is likely to push you into higher rates of tax. But if your company buys the house for your personal use, the amount of taxable benefit will be substantially lower. The benefit will continue to be charged each year, but it may be worthwhile if your income remains below the 45% threshold for the additional rate of income tax (46% in Scotland).

Planning point

Contributions can be made into a registered pension scheme and your company can deduct the contributions when calculating its taxable profits.

PENSION CONTRIBUTIONS

Pension contributions are generally highly tax-efficient. Contributions can be made into a registered pension scheme and your company can deduct the contributions when calculating its taxable profits. The pension contributions will

not be treated as a benefit, so you will not have to pay any income tax and there are no NICs. The funds in the scheme are free of tax on investment income and capital gains. Eventually, when you come to withdraw the benefits on retirement, up to a quarter of the accumulated funds is available as a tax-free lump sum and the balance, however withdrawn, will be subject to income tax but not NICs. However, there are two main catches:

- You will not have any immediate income as a result of the contributions – the funds are locked away until at least age 55 (due to increase to 57 from 2028 and subsequently likely to be fixed at ten years below the state retirement age). So, pension contributions are generally appropriate only after you have taken sufficient income as salary, bonuses and dividends to cover your immediate expenses.
- Pension contributions are effectively restricted to an annual limit of £40,000, lower for high earners.

Although you will not have access to the pension funds, it may be possible in some circumstances for the pension scheme to lend money back to your company or to purchase a property for company use.

RETAINING PROFITS

You might decide to leave surplus profits within your company over and above the capital it would need to maintain the business. This might look preferable given the tax cost of extracting profits and the downside to pension contributions. The only immediate cost to this approach is the corporation tax payable by the company, which is currently at the rate of 19%.

Your company can invest the surplus funds in much the same way as you could personally, for example in shares or investment property. But, of course, at some point you will want to take the surplus funds out of the company.

EXAMPLE**Retaining profits**

Ben and Claire are shareholding directors of LifePlan Holdings Ltd. They have equal shareholdings and the business has retained profits of £100,000

Salary and dividends

The funds could be used to pay salaries and dividends if the company were to go through a poor year or two at some point in the future. In effect they would be averaging out their profits, so that they do not incur higher tax rates in some years and then have little or no income in other years – something that a sole trader or partner cannot do. Another possibility is that Ben and Claire might take a long break from work to travel or spend time with their families.

Future business exit funds

They could leave the funds in the company until they retire, or at least wind down a bit, and then keep withdrawing the same level of income as when they were working full-time. This would also be averaging the taxable profits, but it would operate over a longer timescale. This would almost certainly be significantly less tax efficient than pension contributions, but it would probably be more flexible.

Company wind-up

Ben and Claire could wind up the company and extract the funds as a capital gain. The advantage to this approach is, if the disposal qualifies for entrepreneurs' relief, they will only pay capital gains tax (CGT) at a rate of 10%. Their overall tax rate would then normally be 27% (19% corporation tax and 10% CGT on the remaining 81% of the profit). However, retaining a large amount of surplus funds in their company could mean that entrepreneurs' relief would not be available. They must therefore be careful with this approach. If their shares in the company did not qualify for the relief, the tax rate would be 20% to the extent that the gain exceeded their basic rate income tax band. The combined overall rate would then become a less attractive 35%.

Retiring abroad

They could retire abroad with the possibility of taking their accumulated funds tax free, although the company would still be subject to corporation tax. Following the introduction of the statutory residence test, it is now possible to establish non-UK residence status for individuals with much more certainty than previously. It would be necessary to stay away for more than five years, which should not be a problem if they are retiring. Provided their plans are definite, there is no reason why the funds should not be withdrawn soon after leaving the UK so that they can be used to fund their retirement plans. They would also need to consider their tax position in the country where they settled.



Planning point

Whoever buys your company will normally expect you to extract all the company's cash before a sale. If there are substantial retained funds, you will probably have to start extracting them several years before a sale unless you want to incur a large tax liability.

SELLING YOUR COMPANY

In the longer term you may be in the position to sell your company, especially if it has grown beyond being an owner-manager operation.

It will normally be beneficial for you to sell your company shares rather than for the company to sell its business and assets. If the company sells its business and assets, you will face the problem of extracting the sale proceeds from the company; this could mean a double tax charge.

The most important tax consideration will normally be whether you will qualify for entrepreneurs' relief. The company must be carrying on a qualifying trade and this may not be the case if more than 20% of income or assets are non-trading.

Planning point

It will normally be beneficial for you to sell your company, especially if you have grown beyond being an owner-manager operation.

Any gain could be exempt if you dispose of your shareholding during a period of non-UK residence, although this might not seem so attractive if you are just cashing in your business at a young age and with a family, rather than when you are retiring.

OTHER CONSIDERATIONS

It is important to bear in mind your overall tax and long-term financial position when considering the various options for extracting profits. For example, you do not want to end up unnecessarily losing tax credits or universal credit, losing some or all of your personal allowance, or incurring a child benefit tax charge because you have taken a little too much income.

You may come across clever schemes that, in theory, allow you to withdraw profits from your company at minimal tax cost. But be warned that HMRC is increasingly clamping down on anything it considers to be tax avoidance. For example, until 2011, employee benefit trusts were widely marketed as a way for high earners to reduce their tax liabilities. They typically involved directors and employees taking loans rather

than remuneration, or deferring taking income until their tax position was more advantageous for receiving it. Not surprisingly, such schemes are no longer tax-effective.

As an owner-manager of your own company, you are invariably in a better tax position than employees or the self-employed because you have much more flexibility about when you receive your income and the form it takes.

Planning point

Be warned that HMRC is increasingly clamping down on anything that it considers to be tax avoidance.



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HOW WE CAN HELP

We can help you decide how best to extract profits from your company, and can make sure that all the relevant legal requirements are complied with.

We can help with your company's payroll, or can manage this on your behalf. We can complete all the necessary tax returns both for you and for your company.

We can advise you on longer-term strategies for retirement planning or the possible future sale of your company. We can make you aware of changes in regulations so that you can take appropriate action.

Our aim is to relieve you of tax worries so that you can concentrate on doing your job.



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