



F S P G
CHARTERED ACCOUNTANTS



KEY GUIDE

Drawing profits from a company



Constantly changing tax rules

When you draw profits from an owner-managed company most people are keen to ensure that they do it in a way that minimises the tax and national insurance contributions (NICs) cost.

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 cost, and it will also be necessary to retain sufficient profits within 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 still continues to be the best approach. Company tax rates have fallen considerably in recent years, and the rate of corporation tax has been unified for all companies since April 2015. Another development is the introduction of the statutory residence test, which can make establishing non-UK residence status a more feasible retirement strategy than it previously was, plus the changes to the taxation of dividends which came into force in April 2016.

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 salary and bonuses attract NICs. Employer NICs at the rate of 13.8% kick in once annual remuneration exceeds £8,112 and there is no upper earnings limit. Employee NICs are 12% on earnings between £8,060 and £43,000, and 2% thereafter. So the combined NIC cost is up to 25.8%, although at least the employer portion can be deducted in calculating your company's taxable profits.

It is normally advisable to draw 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 new state pension scheme which came into force on 6 April 2016.

In 2016/17, you are deemed to have made NICs once your annual earnings reach £5,824; so taking a salary between £5,824 and £8,060 gives you the necessary pension entitlement without any NIC cost. But you will need to run a 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.



Action point

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

National living wage	The new national 'living wage is around £13,000 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 income tax-free personal allowance of £11000.
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 in order to forestall HMRC taking an interest in his company. The NICs cost could be high, but it might well be worthwhile to avoid the full force of the IR35 rules being applied.
Tax efficiency	If he does need a higher level of remuneration, then he could take £43,000 before the higher income tax rate of 40% bites. The first £11,000 will be tax-free because of his personal allowance and the next £32,000 will be subject to the basic rate of 20%. Salary and bonuses are taxed under PAYE, so tax and NICs will be payable straight away.



Action point

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.

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 20%) on the amounts paid. A salary between £5,824 and £8,060 would mean they would retain their entitlement to social security benefits without any NICs cost. If you pay more than this, the annual £2,000 employment allowance could help small companies because the first £2,000 of employer's NIC won't be payable.

However, you must be able to justify the cost of the salary on commercial grounds by the work that your spouse, 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 drawings profits out as dividends is that no NICs are payable. So 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. Many owner-managers therefore take a small salary to use up their personal allowance and they then withdraw the remainder of their income as dividends.

Dividends have no effect on your company's tax position, but there will be further tax to pay by the recipient to the extent that dividends exceed the new £5000 tax-free allowance. Any dividend in excess of 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 should they fall for additional rate tax, the rate due will be 38.1%. Whilst the tax-free allowance will benefit those with only a low level of dividend income, the new rates mean an increase in taxation for the majority of business owners extracting profits. Despite this recent tax increase, the difference between the tax and NIC costs of drawing a salary and a dividend can be very substantial, as the following demonstrates:

Example – additional income paid as salary or dividend

Madeline is owner director of a recruitment agency. She has taken just enough salary to use her personal allowance of £11,000, 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 £28,683 to spend. However, taking a dividend would leave her with £35,375 after allowing for her company's corporation tax liability and her personal liability to tax – over £6,500 extra spendable income from profits of £50,000.

There can be some drawbacks to taking a dividend, apart from those already 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 though there may be 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 separate classes 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



Action point

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

taxes. Moreover 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 April following the end of the tax year. This provides a considerable delay especially if you take your dividends early in the tax year, but 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.

Benefits in kind

Does it make sense for your company to provide you with fringe benefits such as a company car or buying property for your personal use? The answer is generally no. 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 pay for the benefit 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, mobile phones (including smart phones) and electric cars are exempt and there is a low tax charge for cars with a low CO ₂ emission. But be warned that the company car rules constantly change, with the electric car exemption having ceased in April 2015, and increases to the appropriate percentage of list price for all but ultra-low emission cars planned every year up to and including 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 well 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 of course continue to be charged each year, but it may be worthwhile if your income remains below the 45% additional rate of income tax



Action point

It will normally be beneficial for you to sell your company shares rather than for the company to sell its business and assets.

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 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 are 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:

- Firstly, 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 fixed at ten years below the state retirement age), So pension contributions are more 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 higher 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 20%.

Your company can invest the surplus funds in much the same way as you could do so 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.



Action point

Whoever buys your company will normally expect you to extract all of 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.

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 fund salary 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 cover a longer timescale. This would almost certainly be significantly less tax efficient than pension contributions, but it would probably be more flexible.

<p>Company wind-up</p>	<p>Ben and Claire could wind up the company and extract the funds as a capital gain. The advantage to this approach is that if the disposal qualifies for entrepreneurs' relief, they will only pay capital gains tax at a rate of 10%. Their overall tax rate would then normally be 28% (20% corporation tax and 10% CGT on the remaining 80% 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 this 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 36%.</p>
<p>Retiring abroad</p>	<p>They could retire abroad with the possibility of taking their accumulated funds tax free, although the company would still have been subject to corporation tax. Following the introduction of the statutory residence test it is now possible to establish non-UK residence status 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 were retiring. And provided their plans were 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.</p>



Action point

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

Selling your company

In the longer term you may be in the position to sell your company, especially if you have 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 have to 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 a qualifying trade and this may not be the case if more than 20% of income or assets are non-trading.

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 would allow you to withdraw profits from your company at minimal tax cost. But be warned that HMRC is increasingly clamping down on anything that 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 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.

How we can help

We can help you decide how best to extract profits from your company, and can make sure that all the current and proposed 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.

In a constantly changing tax environment, our aim is to relieve you of tax worries so that you can concentrate on doing your job.

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FSPG Chartered Accountants

21 Bedford Square London WC1B 3HH
Telephone: 020-7637 4444 Fax: 020-7323 2857
E-Mail: admin@fspg.co.uk Web: www.fspg.co.uk

Contacts

Jon Glasner FCA, BSc Howard Presky FCA Ian Fenton FCA Jayendra K. Shah FCCA, CTA
David Tropp FCA Khalid Q Rana FCCA Paul Maurice FCA, CTA Anthony Cohen FCA

Consultant

Ian A. Sussman FCA

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