CHARTERED
ACCOUNTANTS

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.

EXCEPTIONAL CIRCUMSTANCES

The Covid-19 crisis has altered the landscape significantly for individuals and business owners alike. The government announced a number of schemes which you may be taking advantage of to get through the crisis, including the Coronavirus Job Retention Scheme.

Even for those whose businesses have not stalled, the tax rules are still 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 trend is set to reverse. The March 2021 Budget proposed that corporate tax for companies with profits in excess of £50,000 should rise to a maximum of 25% from April 2023. 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. There may be environmental-related tax changes in the near future. These should be assessed carefully and monitored regularly for impacts on your business.

Contents

SALARY AND BONUSES

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

BENEFITS AND PENSIONS

How you can extract profit from your company to contribute to your pension, or pay for other benefits

DIVIDENDS

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

This publication is for general information and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking any action on the basis of the contents of this publication. This publication represents our understanding of law and HM Revenue & Customs practice as at 6 April 2021.

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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 £8,840 (in 2021/22) and there is no upper earnings limit. Employee NICs are 12% on earnings between £9,568 and £50,270, 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 scheme, which came into force on 6 April 2016.

In a tax year where your earnings are at least £6,240 (the 2021/22 level) you will be treated as having paid NICs in your contribution records, thus preserving benefit rights, even though no contributions are actually paid unless earnings exceed £9,568. 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 £15,000 a year for over 23s, 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 £12,570 in 2021/22.
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.
Off-payroll working (IR35) rules	If there is a chance that his company could be classified as a personal service company (PSC) under the off-payroll working (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 off-payroll working rules being applied.
Tax efficiency	If he does need a higher level of remuneration, he could take £50,270 before the higher income tax rate of 40% bites. The first £12,570 will be tax-free because of his personal allowance and the next £37,700 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, civil partner or family members have little or no income, it can be beneficial for your company to employ them as a way of extracting profits.

The much-publicised proposal to strengthen the off-payroll working rules has now come into effect from April 2021, postponed from the original start date of 2020. The new rules require medium and large private sector companies to determine the employment status of individuals who provide them with services through personal service companies.

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 approximately £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 £6,240 and £9,568 would mean they retain their entitlement to social security benefits without any NICs cost.

If you pay more than this, the annual £4,000 employment allowance could help small companies, because the first £4,000 of employer's NIC won't be payable. This employment allowance cannot be claimed where directors 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 (2021/22). Any dividend over the allowance, but within the basic rate band for income tax, will be taxed at 7.5%.

Credit: iStock/clearviewstock

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 significant, as the following example demonstrates.

EXAMPLE
Additional income paid as salary or dividend

Madeline is owner-director of a recruitment agency in Wales. In 2021/22 she has taken just enough salary to use her personal allowance of £12,570, 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 over £32,000 to spend. However, taking a dividend would leave her with just over £33,000 after allowing for her company's corporation tax liability and her personal liability to tax.

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 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 account 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 a salary or bonus.

Credit: iStock/JohnnyGreig

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 low- or zero-emission 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 CO_2 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. From April 2020, a new regime was introduced for taxing car benefits. The objective of this new approach is to reflect the environmental impact of vehicles more closely in the tax system.
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).

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.

Planning point

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

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 business asset disposal relief (formerly entrepreneurs' relief) they will only pay capital gains tax (CGT) at a rate of 10%. For disposals of qualifying assets from 11 March 2020 onwards, the 10% rate applies to a lifetime maximum of £1m gains, reduced from the previous level of £10m. If business asset disposal relief applies, their overall tax rate would 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 business asset disposal 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. However, now that the UK has left the EU, a review of any plans they made earlier would be advisable.

Credit: iStock/Oat_Phawat

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.

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.

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 business asset disposal relief, bearing in mind the reduced lifetime limit of £1m from 11 March 2020. 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.

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.

Planning point

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

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.

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 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. In addition, we can provide you with details on how the consequences of Brexit will affect your business and offer advice on any tax, financial or business planning arrangements which you could consider. Our aim is to relieve you of tax worries so that you can concentrate on doing your job.

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We are delighted to announce the launch of our free App!

The App will give you access to key accounting data, in real time, whenever you need it, as well as a suite of powerful calculators. It brings all the financial tools you use together into one easy to use tool.

It's available for iPhone, iPad and Android devices free of charge today. Simply download the App by searching for MYAccountants in the App store on your device, and when prompted, enter the access code: **BGMApp**

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