Extracting company profits in 2017-18

Overview

Company owners wishing to extract profits from their companies as tax efficiently as possible face an array of conflicting and ever-changing factors.

When companies make profits, there are essentially a number of available methods that profits can be extracted from companies’ funds:

1) Reward their directors and employees by means of remuneration (salary, bonuses, benefits etc.);
2) Distribute profits to their shareholders by way of dividends;
3) Company pension contribution;
4) Payment of rent (where the property is rented by a director/shareholder);
5) Interest (where loans have been made to the company);
6) Capital distribution.

This brief will aim to explore various methods in which profits can be extracted from a company by its shareholders and employees, and the tax implication of each of them.

1. Remuneration

The most obvious way to move the profit from the company to you is by paying yourself a salary. Since you do not pay any tax on the first £11,500, you will pay 20% income tax on any salary you take that is between £11,500 and £45,000. If you go over that threshold your income tax liability shifts to 40%.

If you are a director you can pay yourself a salary at level of £8,164 per year (£680.33 per month) for 2017/18 and still be able to enjoy the benefit of state pension entitlement and no National Insurance Contributions (NIC). Where remuneration is paid in cash form (such as a salary, bonus payment), the employee is liable to income tax and Class 1 NICs (12% and/or 2%) unless the taxpayer is not liable to NIC e.g. due to being over the State Pension age. The employer company will also be liable for secondary Class 1 NICs (13.8%) on the remuneration paid. Tax and NIC must be deducted at source by the company under PAYE. The salary and any Class 1 NIC liability is also deductible for corporation tax purposes.

Due to the availability of the £3,000 employment allowance, it will be beneficial for directors of companies with two directors (e.g. husband and wife) to pay themselves a core salary of £11,500 (i.e. up to the level of the personal allowance) where the employment allowance would otherwise not be used.

2. Dividend

Companies typically distribute their profits to shareholders by way of dividends. Dividends are chargeable to income tax. However, dividends are not earnings for NIC purposes (unless they are deemed to be a salary) so dividend payments are not subject to NIC.
This is the case even if the shareholder is also an employee or director of the company. Dividends can be paid at any time as long as the company has sufficient distributable profits.

The taxation of dividends changed significantly from 6 April 2016. The rates of income tax for the 2017/18 tax year are as follows:

<table>
<thead>
<tr>
<th>Allowance</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend allowance (£5,000)</td>
<td>0%</td>
</tr>
<tr>
<td>Basic rate band</td>
<td>7.50%</td>
</tr>
<tr>
<td>Higher rate band</td>
<td>32.50%</td>
</tr>
<tr>
<td>Additional rate band</td>
<td>38.10%</td>
</tr>
</tbody>
</table>

There is no tax on the dividend income which is covered by the remaining personal allowance nor on the dividend income within the dividend allowance of £5,000 (set to reduce to £2,000 from 6 April 2018 – under current proposals).

It will usually be more efficient from the individual's perspective to extract funds by way of a dividend rather than by salary or bonus given the higher rate of tax on remuneration. The dividend route also removes the employer from an obligation to pay 13.8% secondary NICs.

However, dividends are not deductible for corporation tax purposes and dividends are not treated as earnings for pension purposes (although the shareholder could still make gross pension contributions of £3,600 per annum where they have no earnings in any event).

This is a more attractive option than the simple remuneration route unless the director/employee is exempt from paying the NIC contributions.

3. Pension contribution

Pension contribution is the most tax-efficient method of extracting profits from a company.

Providing pension contributions are not deemed excessive for the duties carried out by the director/employee, such contributions can be deducted from the company’s taxable profits. Consequently, these contributions will receive a corporation tax relief.

If pension contributions do not exceed the director/ employee’s pension ‘annual allowance’ they will not be subject to tax on the contribution made.

Given this tax efficiency, pension contributions should be considered where the director/employee does not need the funds in their hands.

4. Rent

If an individual owns a property which the company uses in its trade, rent could be charged to the company for the use of that property. The rent (less any allowable expenses) is chargeable to income tax but are not earnings for NIC purposes (thereby enabling an NIC-free extraction of funds). The rental payments are deductible for the company for corporation tax (subject to reasonableness).
The disadvantages of receiving rental income by the company is that the income is charged at the non-
savings rate of 20%, 40% or 45% (thereby making it less tax efficient than taking a dividend).

The most significant downside is the fact that by charging a rent you restrict your ability to claim capital
gains Entrepreneurs Relief (ER) (resulting in the 10% capital gains tax rate) on any gain arising on the
sale of the property.

Please also note that irrespective of whether rent is paid, holding property outside of a trading
company (when a property from which the trade is carried out is held personally) is usually inefficient
from an inheritance tax perspective.

5. Interest

Some directors/shareholders lend money to the company, either by simple loan account or via a
subscription for loan stock or debenture stock.

The director/shareholder can charge interest to the company in this scenario. The interest received is
chargeable to income tax but is not earnings for NIC purposes (again enabling an NIC-free extraction).
A rate of 0% applies to interest within an individual’s savings allowance. If the individual does not have
higher rate income, the savings allowance is £1,000. If the individual has higher rate income but does
not have additional rate income, the allowance is £500. It is nil for individuals with additional rate
income. The interest payments are normally deductible for the company under the loan relationships
rules (subject to reasonableness).

Where a UK company pays interest to an individual, it must withhold 20% income tax at source and
submit CT61 returns to HMRC which can be a burden from an administration perspective.

6. Capital Routes

With Capital Gains Tax (CGT) rates being 10% for basic rate taxpayers and only 20% for
higher/additional rate taxpayers, this way of extracting funds would be an ideal as it generally
compares favorably with the effective rates of income tax on remuneration and dividends. If
Entrepreneurs’ Relief (ER) is available, the CGT rate is reduced to 10%, regardless of the taxpayer’s
level of taxable income.

In addition, all taxpayers have an annual exemption which means that the first £11,300 per annum (in
2017/18) of capital gains are not charged to tax (and typically most UK taxpayers do not make use of
this CGT exemption).

Cash taken out of company can be treated as capital proceeds for CGT purposes if extracted in the
following ways:

   I. Company Purchase of Own Shares (CPOS);
   II. Capital redemption/return of capital, or
   III. Distributions on winding up of a company.
Company Purchase of Own Shares (CPOS)

Normally payments by companies to buy back shares from individuals are treated as income distributions (i.e. dividends). These distributions are therefore liable to income tax at the dividend rates as discussed above.

However if certain conditions are met, the cash received from the buy-back is treated as a capital sum on a disposal of the shares. This gives rise to a capital gain in the hands of the shareholder. For most shareholders, the capital route will be beneficial, particularly if entrepreneurs’ relief is available. This capital treatment only applies to purchases of own shares by unquoted trading companies where the repurchase is made either: to benefit the trade; or to discharge an IHT liability as a result of death.

Where the individual is seeking capital treatment under the “benefit of trade” route, there are several other conditions which must be satisfied.

A clearance procedure is available in order to request HMRC’s opinion as to whether proceeds will be treated as a capital distribution (as opposed to a dividend). Advice should be sought based on your specific circumstances.

Capital redemption/Return of capital

A company may restructure its share capital or issue redeemable securities to return money to shareholders. This can give shareholders a great flexibility in when and how to take their money.

Distributions on Winding up of a Company

There will eventually come a time when the company has run its course, is no longer required by its shareholders and can therefore be wound-up. The company will then cease trading, sell its assets, discharge its liabilities and, if there are any surplus assets left (most commonly cash), it will distribute those assets to its shareholders.

Prior to 6 April 2016 distributions received on a winding up or liquidation of a company (or in a capital redemption/return of capital) were always treated as a capital distribution. From 6 April 2016 such a distribution can be deemed as dividend and taxed as such (resulting in a significantly higher tax charge in most cases). Consequently, there is a risk here, particularly for companies with reserves. This is another area where advice should be sought.

It is possible to apply to HMRC for a clearance in order to seek their opinion as to whether these anti-avoidance provisions would be involved (and thus the distributions being treated as dividend income).

If you would like to find out more about the profit extraction and how we at Robinson Reed Layton can assist, please contact our Tax Partner, Steve Maggs, on 01872 276116 or steve.maggs@rlcornwall.co.uk

This publication has been prepared by Robinson Reed Layton. It is to be treated as a general guide only and is not intended to be a comprehensive statement of the law or represent specific tax advice. No liability is accepted for the opinions it contains, or for any errors or omissions. All rights reserved.