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Tax efficient profit extraction for the family company

Another tax year has started and, as always in the world of tax, nothing stays the same. There are a number of methods of extracting funds from your own limited company and in this Briefing we consider the main options for extracting profit.

The main options are

- remuneration
- dividends
- pension contributions.

Recent changes in the taxation of interest receipts give further opportunities for tax savings, so we will consider this option as well.

What is better, pay or dividends?

As always, it depends. Dividends are often used in combination with remuneration to obtain the most tax effective extraction of profits when the business is carried on through a company. For many years it has been attractive to pay a small salary to allow the tax efficient use of the personal allowance, to provide a corporation tax deduction for the company but not to pay National Insurance contributions (NICs). This means a salary of £8,164 in 2017/18, corresponding to the primary NICs threshold. The payment of this level of salary also provides a qualifying year entitlement to the state pension.

When the new tax regime for dividends was introduced in April 2016, many director-shareholders found that the tax bill on the dividends was higher than before. So does this change the strategy of low salary and the balance as dividends?

The Dividend Allowance of £5,000 does not change the amount of income that is brought into the income tax computation. Instead, it charges the first £5,000 of dividend income at 0% tax - the dividend nil rate. This means that:

- the payment of low salary below the personal allowance will allow some dividends to escape tax as they are covered by the personal allowance, and
- the £5,000 allowance effectively reduces the available basic rate band for the rest of the dividend.

The practical effect of the new regime is that a strategy of low salary and the balance of income requirements taken as dividends will still be a tax efficient route for profit extraction for many director-shareholders. This is likely to be the case even when the Allowance reduces to £2,000 in April 2018.

Example – higher rate taxpayer

George wants to receive £60,000 after all taxes from his family company. He has a marginal income tax rate of 40% (32.5% if dividends) for 2017/18. He already has earnings above the employee upper earnings limit for NICs purposes so that any bonus will only be liable to employee NICs at 2% rather than at 12%. The company pays corporation tax at 19%.

To provide George with £60,000 after taxes, the company would have to pay a dividend of £88,889 or a bonus of £103,448.

How much does the above cost the company?

The cost to the company of paying a dividend will be £88,889. The company will have to pay employer NICs @ 13.8% of £14,276 on the bonus making the gross cost £117,724. It will get tax relief on this however so the net cost will be £95,356.

The bonus therefore costs the company rather more than the cost of the dividend. The savings would be higher if George has only taken so far a basic salary of £8,164. Part of the bonus would then trigger an employee NIC cost at 12% rather than 2%.

What if the director-shareholder has made loans to the company and could charge interest?

Interest receipts are the main category of savings income. There are two tax breaks which can apply to savings income. One is the Savings Allowance which was introduced from April 2016. The Savings Allowance, which is £1,000 for basic rate taxpayers and

£500 for higher rate taxpayers, charges interest up to these amounts at 0%.

The other tax break on savings income, the 0% starting rate of tax on savings income, has been around for many years but until recently it did not provide significant tax savings. The 0% starting band now potentially applies to £5,000 of savings income. This rate is not available if 'taxable non-savings income' (broadly earnings, pensions, trading profits and property income) exceeds the starting rate limit. However, dividends are taxed after savings income and thus are not included in the individual's 'taxable non-savings income'.

Where does the interest come from? The director-shareholder may have provided loans to their company. Many have not charged interest on such loans but there is now an added incentive to do so.

Example

Mary is a director-shareholder and has made loans to her company to provide for the long-term capital needs of the company. She has not charged interest on the finance in the past but she may be able to charge £5,000 a year based on the amount she has lent and a market rate of interest. She takes a small salary (approximately £8,000) and the balance as dividends (typically about £50,000). The salary would be covered by the personal allowance (which is £11,500 for 2017/18), with the dividend receiving the benefit of the remainder of the personal allowance – so £3,500. The rest of the dividend would be taxed at Dividend Allowance rate (0%), basic rate (7.5%) and higher rate (32.5%).

If £5,000 of interest was received and the dividend reduced by £5,000 to compensate, there is an opportunity to benefit from the 0% starting rate on £5,000 of the interest. Personal allowances can be allocated in the way which will result in the greatest reduction in the taxpayer's liability to income tax and so, in this example, £3,500 would still be allocated to dividends as in the previous paragraph. Mary would have the benefit of the £5,000 interest being tax free rather than £5,000 dividends taxed at 7.5% (a saving of £375). There would also be a saving to the company as the interest paid is generally deductible from taxable profits which gives a saving of £5,000 at 19% (£950).

This is just another example of how complex our tax system has become.

What about family members?

Companies often seek to minimise the tax position of director-shareholders by involving members of the same family and using personal reliefs and lower rate tax bands of each person. Income is therefore diverted from the higher rate taxpayer. However, anti-avoidance rules need to be considered as to whether a diversion is effective. This is particularly relevant for married couples.

Where it is considered that arrangements have been made by one spouse which contain a gift element, then the 'settlements' rules may apply and the person who made the gift, rather than the recipient of the income, will be taxable on that income. A key purpose of these rules is to ensure that income alone or a right to income is not diverted from one spouse to the other. Genuine outright gifts of 'normal' share capital from which income then wholly belongs to the other spouse are not caught by the rules because of a specific exemption from the settlement rules.

Family company shares and the dividend income derived therefrom can be challenged by HMRC in some cases. An example of a structure which may be challenged is the issue of a separate class of shares with very restricted rights to a spouse, with the other spouse owning the voting ordinary shares. Another area of potential risk is the recurrent use of dividend waivers particularly where the level of profits is insufficient to pay a dividend to one spouse without the other waiving dividends.

Basic tax planning is still an activity that many will seek to use to mitigate tax liabilities but care has to be taken in the current anti-avoidance environment to avoid the traps. If we can be of assistance in reviewing your position please do not hesitate to contact us.

Pensions

Pensions are much maligned but there aren't many other investments where the government is keen to give 40% tax relief for higher rate taxpayers.

Relief for individuals' contributions

An individual is entitled to make contributions and receive tax relief on the higher of £3,600 or 100% of earnings in any given tax year, so with a small salary as referred to above, this doesn't take director-shareholders very far.

Company contributions

A company will normally obtain a tax deduction against its profits for pension contributions. The contributions must be paid before the end of the accounting period in order to obtain a tax deduction in that period. Employer pension contributions are tax and NIC free to the director-shareholder as long as the 'Annual Allowance' of the director-shareholder is not exceeded.

Broadly, the Annual Allowance is £40,000 per tax year but unused amounts of £40,000 from three previous years may be able to be brought forward. However, there are complex rules which apply to those with 'adjusted income' over £150,000, which can reduce the Annual Allowance to as little as £10,000, so detailed advice should be taken before any pension planning is undertaken. The following example helps explain the potential benefits.

Example

Albert is the director-shareholder in a company which has a 31 March year end. In the past he has taken low salaries and high dividends. The company expects to make large profits in the year to 31 March 2018.

The company has made annual contributions into Albert's pension scheme of £20,000 for a number of years. He wants to consider the effects of the company making larger pension contributions on his behalf.

What amounts could be paid into a pension scheme on his behalf in 2017/18?

In simple terms inputs made in each of the three previous years have been £20,000.

Albert could have a £100,000 contribution without an Annual Allowance charge arising on him. This is made up of £40,000 for 2017/18 and unused relief in each of the three previous years of £20,000 a year.

The minimum amount that should be considered if Albert wishes to avoid any loss to allowances would be £60,000 as that would use up his 2017/18 AA and the 2014/15 unused AA. Next year a further payment could be paid (using up his 2018/19 AA and the unused AA from 2015/16). His 2016/17 unused AA could be used in 2019/20.

For years after that, payments would be limited to the AA.

So where does this leave us?

It is always important that the tax tail does not wag the commercial dog. It is also clear that the tax system allows savings with appropriate planning but also that care is required. We are here to help guide you through the tax maze and if anything in the Briefing has sparked your interest, please do get in touch.