FINANCE UPDATES

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HB Dobbin

FINANCIAL PLANNING

HOW TO EXTRACT PROFITS FROM YOUR COMPANY

Tax-efficient options for limited company directors.

If you run your own limited company, you choose how much to pay yourself, pick your own payday, and how you will be paid.

With more people working for themselves, that may sound appealing. But the reality is the money you work so hard to make goes into the business bank account, not your own.

Should you take money out of the business account inefficiently you may pay more tax than necessary, and if you take money out in the wrong way, you might be on the wrong side of some expensive tax penalties.

This is what we look to predict for tax-efficiency purposes, and where expert financial planning for business owners can help when it comes to extracting profits.

MANAGING YOUR TAX LIABILITY

First things first, managing your tax liability is not breaking any rules, and no rule states you must extract profits from your business in a specific way to pay the most tax to the Treasury.

With help from our independent financial advisers, you can organise your tax affairs to ensure you pay the minimum amount of tax and stay within the rules.

In 2020/21, there are three main routes for limited company owners to pay themselves. These are salary, dividends, and pension contributions. Combining these options is usually the most tax-efficient method.

SALARY

If you own a company, you can reduce your tax bill by paying yourself a small salary and taking other income as dividends.

In 2020/21, your salary will become liable for income tax as soon as you pay yourself more than £12,500.

Exceeding this threshold up to £50,000 attracts income tax at 20%, income over £50,000 up to £150,000 is charged at 40%, and income above £150,000 will result in a 45% charge.

You can see how paying yourself up to £12,500 in 2020/21 is the most tax-efficient method for extracting profits as salary.

Not only does a small salary mean paying less income tax, it means making lower National Insurance contributions (NICs). However, paying less NICs affects state pension accruals over time and you may not achieve full state pension benefits.

If you are on payroll this year and stand to receive £12,500, you will pay 12% in employee's NICs while the company will pay 13.8% in employers' NICs on your wages. These contributions go towards state benefits, including your state pension.

A tax-efficient way to pay less income tax and still extract £100,000 in 2020/21 is to make use of your £12,500 personal allowance and take £87,500 as dividends.

DIVIDENDS

Not so long ago, a 10% tax credit made dividends a popular tax-efficient strategy when it came to extracting profits from a company. That was replaced by a £5,000 dividend allowance in 2016/17, which fell to £2,000 in 2018/19.

The way dividends are taxed can still reduce or eradicate your income tax bill as you can only pay dividends on profits your company generates which is liable to a 19% corporation tax charge in 2020/21.

Every owner of a limited company can take up to £2,000 of dividends tax-free this year, assuming the allowance has not been used up by other payments you have received.

For example, any investments that pay dividends in 2020/21 will erode your £2,000 annual dividends allowance.

How much tax is owed on dividends above this allowance depends on your marginal rate of income tax:

Income tax band (2020/21)	Rate
Basic-rate	7.5%
Higher-rate	32.5%
Additional-rate	38.1%

PENSION CONTRIBUTIONS

Extracting profits from your company in the form of employer pension contributions has become more popular in recent years, especially in light of changes to the tax treatment of dividends.

Where the total pension contributions paid by you or on your behalf lie within your annual allowance, usually £40,000 a year, there is no tax charge when the contributions are paid.

For example, if you take total taxable income of up to £200,000 in 2020/21, your company could put up to £40,000 of that into your pension without being charged tax.

A separate allowance allows you to build up a lifetime value of £1,073,100 in your pension pot. That's a considerable amount of money wrapped in a tax-efficient fund, which sits outside of your business – and potentially out of creditors' reach.

SSAS Pensions

Another pension option, usually for directors of private or family-run companies, is to make use of small self-administered schemes (SSAS).

These are usually limited to 11 people, including senior or key staff, employees and family members, and offer control, flexibility and tax-efficiency.

Current SSAS rules can provide loans worth up to 50% of the total amount held in your business, offering a valuable source of extra funds, although conditions apply.

SSAS loans must be for a genuine investment and the company needs to repay the loan at a reasonable rate of interest. But, that is usually lower than those offered by commercial lenders.

With the SSAS, a real investment could use your pension fund to buy back shares prior to an exit or to purchase another company.

Alternatively, it could be used to buy major capital equipment or to fund any other business initiative that might generate a sizable return.

Using your pension fund in this way, however, carries a degree of risk. As always, speak to us for expert pensions advice before making any big decisions.

SEEK INDEPENDENT ADVICE

Even though there are a limited number of options for extracting profits from your company, each option has its own specific tax and national insurance challenges which makes seeking professional guidance essential.

For higher earners or high-income individuals, these rules can be further complicated by the tapered annual pensions allowance.

This comes into play for high-income individuals with 'adjusted income' of over £240,000, and 'threshold income' of more than £200,000 in 2020/21.

Our experts know the careful steps to take to protect your wealth and reduce your tax liability prior to profit extraction, and how those profits can be integrated into your wider financial plans.

Speak to us about extracting profits.

IMPORTANT INFORMATION

The way in which tax charges (or tax relief, as appropriate) are applied depends on individual circumstances and may be subject to future change. Pensions eligibility depends on individual circumstances.

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