

Profit extraction in OMBs (Lecture P1304 – 17.38 minutes)

It is common within the owner-managed business population to have an individual who is both director and shareholder of a company.

When considering how to extract money from the company in a tax-efficient way, we are normally thinking about the difference between salary and dividends.

There is a subsidiary issue involving loan interest (where money has been lent to the company by the individual) and rental income (where it is possible to purchase business premises outside the main company) but these are not really going to generate the main income for a household other than in a few cases.

Looking at the two options is superficially straightforward. Salary payments will be tax deductible in the company but attract tax and National Insurance for both the payer and the payee. Dividend payments are not tax deductible for the company but will only attract tax and not NICs.

The following calculations are very simplified but are really to make a general comparison between the different options. We are assuming that the personal allowance has already been used as well as the dividend allowance. We are also ignoring any employment allowance that might be available at this stage.

In reality, most director/shareholders will already be paying up to the lower earnings limit for NI purposes in order to guarantee the year qualifies for state pension purposes so we are really looking at how we top-up the main income.

Calculations – basic rate taxpayer

a) Bonus

Gross	100.00
Secondary class 1 NIC $\left[\frac{13.8}{113.8} \right]$	<u>(12.12)</u>
Gross salary	87.88
Income tax and NIC at 32%	<u>(28.12)</u>
Retained	<u>59.76</u>
Total tax and NI cost	40.24%

b) Dividends

For dividends, it is assumed that the dividend tax allowance has already been utilised.

Gross	100.00
Less corporation tax (19%)	<u>(19.00)</u>
Gross dividend	81.00
Income tax 7.5%	<u>(6.08)</u>
Retained	<u>74.92</u>

Total tax and NI cost 25.08%

The following table compares the different tax burdens:

	Basic rate taxpayer	Higher rate taxpayer	Additional rate taxpayer
Salary	40.24%	49.03%	53.42%
Dividends	25.08%	45.33%	49.86%

It is clear to see that for all taxpayers it is more beneficial to pay dividends than salary although clients are often surprised at how small the differential is between the two for higher rate or additional rate taxpayers.

What is the impact of the changes in April 2022?

These figures will go up next year with the new Health and Social Care Levy.

The calculations are exactly the same except that the rates of NIC are going up as are the dividend tax rates. Repeating the same calculations as shown above gives us the following figures:

a) Bonus

Gross	100.00
Secondary class 1 NIC $\left[\frac{13.8}{113.8} \right]$	<u>(12.12)</u>
Gross salary	87.88
Income tax and NIC at 32%	<u>(28.12)</u>
Retained	<u>59.76</u>
Total tax and NI cost	40.24%

b) Dividends

For dividends, it is assumed that the dividend tax allowance has already been utilised.

Gross	100.00
Less corporation tax (20%)	<u>(19.00)</u>
Gross dividend	81.00
Income tax 7.5%	<u>(6.08)</u>
Retained	<u>74.92</u>

	Basic rate taxpayer	Higher rate taxpayer	Additional rate taxpayer
Salary	41.98%	50.67%	55.02%
Dividends	26.09%	46.34%	50.87%

Given that the rate of NIC and the rate of dividend tax is going up by the same amount, it is unsurprising that the change affects both marginal rates of tax and there is still a similar differential between the two.

What about the changes in April 2023?

The figures then change again when the rate of corporation tax goes up in 2023 since the tax rate for dividends depends on the marginal rate of tax of the company as dividends are not tax deductible. This change will not affect the marginal rate of tax for salaries.

	Basic rate taxpayer	Higher rate taxpayer	Additional rate taxpayer
Salary	41.98%	50.67%	55.02%
Dividends			
19% CT	26.09%	46.34%	50.87%
26.5% CT	32.93%	51.31%	55.42%
25% CT	31.56%	50.31%	54.51%

This shows that once we get up to the marginal rate of tax (applying between £50,000 and £250,000 for a standalone company), the salary route is actually more tax effective due to the increased benefit of the corporation tax deduction. This was seen before when the marginal rates of tax were higher – when we had a tiered corporation tax system. In that situation you might think it would be better to take salary to bring profits down to the small profits rate and then take dividends if you wanted to take more income.

However, when the calculations are done, it is an interesting situation. You have to do the calculations as it is not easy to predict the outcome. There may not be an overall tax saving or the overall tax may be reduced by this strategy but the amount of money extracted by the individual could be less, because you are reducing the corporation tax payable, not the individual tax.

For example, if you had a standalone company with profits of £75,000 after deduction of a salary at the level of the personal allowance (set at this level to make the calculation easier!). They want to pay £50,000 gross to the individual as either dividends or salary.

Option 1: pay salary of £50,000

Employers NICs = $£50,000 \times 15.05\% = £7,525$

Corporation tax = $(£75,000 - £50,000 - £7,525) \times 19\% = £3,320.25$

NIC on director: salary of £12,570 already paid, so £37,700 @ 13.25% plus £12,300 @ 3.25% = £5,241.25

Tax on director: £37,700 @ 20% plus £12,300 @ 40% = £12,460

Total tax payable = £28,546.50

Net take home for director = £32,298.75

Option 2: pay dividends of £50,000

No NICs due

Corporation tax = $(£50,000 \times 19\%) + (£25,000 \times 26.5\%) = £16,125$

Tax on director = $(£2,000 @ \text{nil}) + (£35,700 @ 8.75\%) + (£12,300 @ 33.75\%) = £7,275$

Total tax payable = £23,400

Net take home for director = £42,725

Option 3: pay salary to bring profits down to £50,000 and then balance as dividends

Want net deduction of £25,000 so $15.05/115.05 = £3,270.32$ which then gives salary of £21,729

Balance as dividend = $£50,000 - £21,729 = £28,271$

Corporation tax = $£50,000 \times 19\% = £9,500$

NIC on director: £21,729 @ 13.25% = £2,879

Tax on director: $(£21,729 @ 20\%) + (£2,000 @ \text{nil}) + (£13,971 @ 8.75\%) + (£12,300 @ 33.75\%) = £9,719.51$

Total tax payable = £25,368.83

Net take home for director = £37,401.49

Best outcome

In this situation, you can see that it still makes sense to pay dividends because so much of the income is being taxed at basic rate, where the difference between salary and dividends is so great. If you had the same individual who had other income so that they were being taxed at higher rates, the figures might be different. You just have to do the calculations.

Capital gains tax rates

Interesting, if no money was extracted on an annual basis but the funds were retained in the company and then extracted subsequently as a capital distribution, the following marginal rates of tax would apply:

	BADR	No BADR basic rate	No BADR higher rate
19% CT	27.1%	27.1%	35.2%
26.5% CT	33.85%	33.85%	41.2%
25% CT	32.5%	32.5%	40%

Other ways of extracting value

Payments to pension funds

Pension contributions are seen as a good way of extracting money from companies. SIPPs and SSASs are well suited to family companies as they may only be used for a small number of members. Trustees of the scheme are responsible for the management of the scheme investments subject to strict statutory requirements to prevent abuse of the funds.

Care needs to be taken since the annual allowance is £40,000 (although the availability of limited carry forward means this figure can be higher) which will limit the overall capacity of businesses to make large contributions but with beneficiaries having more freedom over how to use the money on retirement, there is likely to be increased use of pension funds. Care also needs to be taken for higher earners to make sure that the pension allowance is not tapered away. Any contributions made by a company are not a benefit and would be paid gross. It does, however, count towards the annual allowance and it is important to appreciate this point.

Family wages

The area of spouse's wages (or other family members) is a difficult area because in order to obtain a trading deduction the amount paid must be commensurate with the work done and the arms' length rate for the job. It is actually providing the evidence to support the claim that can cause the greatest problems since Inspectors tend to be sceptical if no evidence exists. However, in most cases it should be fairly easy to justify payments of up to the personal allowance for part time administrative assistance.

Renting an office

Individuals are increasingly using part of their own home for business purposes. Any payments to compensate employees or directors who use part of their home for the purposes of their employment are unlikely to have a s336 ITEPA claim agreed.

An alternative approach would be for the company to rent part of the employee's residence from the employee under a formal rental agreement. In these instances, the Revenue will normally allow a corporation tax deduction for the rent and will not regard the payment as emoluments. The rent would be taxed on the individual as property income with due relief given for costs incurred wholly and exclusively for the purposes of the property business. This is far more generous than a s336 ITEPA claim. It also has the added advantage of avoiding National Insurance. There may be some issue with PPR if there is exclusive use

There is a theoretical possibility that HMRC will argue that rent being paid for occupation of property owned by the director is more than market value. If the director is taxable at higher rate, and the company getting a deduction at 20%, this is unlikely but not impossible. It may depend on whether the director is paying tax on the rent (which might depend on the expenses being claimed). If there is an overpayment of rent (from the perspective of HMRC), it is likely that HMRC will try to tax the overpayment as remuneration. In many ways, it is likely that this will only happen where the amounts are really excessive.

Loan interest

One possibility which is often considered is the possibility of being able to extract money out of the company as interest to utilise the savings allowances where there is a credit balance on a director's loan account. The following is an example of how this might work in practice.

Harry has a director's loan account of £150,000 which arose when he incorporated his business in 2013. He draws a salary in 2022/23 of £9,100 (below the NI threshold), interest at 6% on his loan account, giving £9,000 which is tax free (£3,470 within the personal allowance, £1,000 personal savings allowance and £4,530 attracting the savings starting rate of zero) and dividends of £2,000 which are also tax free. This provides him with £20,100. Further dividends can be drawn within the basic rate band as they suffer tax of only 8.75% in addition to the corporation tax which will be paid in any event. He can take income of £50,270 at a tax cost of only £2,639.87.

The profits needed to generate dividends of £30,170 in the circumstances above are calculated below.

	£	£
Profit		55,347
Interest on loan account	9,000	
Salary	<u>9,100</u>	<u>18,100</u>
Taxable profit		37,247
Corporation tax at 19%		<u>7,077</u>
Net profit (= dividend)		<u>30,170</u>

The total tax payable is £7,077 plus £2639.87 which is a marginal rate of tax of 17.5%.

Contributed by Ros Martin