3 MINUTE GUIDE

WAYS TO EXTRACT CASH FROM YOUR COMPANY

Where a business is operated as a company, profits need to be extracted in order for the directors and shareholders to be able to utilise those profits outside the company.

Profits can be extracted in a number of ways, the tax and National insurance implications of which vary.

PLANNING

A company pays corporation tax on its profits. In calculating those profits, some payments that may be made to directors, such as payments of salary and wages, benefits in kind, rent for the use of a home office, mileage payments, and such like, are deductible.

By contrast, dividends paid to shareholders are paid from profits which have already suffered corporation tax. When extracting profits from a family or personal company, the tax and National Insurance implications should be taken into account to ensure that profits are extracted in a tax efficient manner.
A conventional strategy is to pay a small salary and extract further profits as dividends.

As long as the personal allowance is not used elsewhere, the optimal salary depends on whether the National Insurance employment allowance is available. The allowance, which is set against employer Class 1 National Insurance contributions of up to £4,000 in the tax year, is not available to companies where the sole employee is also the director. Thus, personal companies will not benefit from the allowance, although family companies may.

Where the allowance is not available, the optimal salary is one equal to the primary and secondary threshold for National Insurance purposes - set at £8,784 for 2020/ 21. At this level, no tax or National Insurance is payable.

Further, the salary is deductible for corporation tax purposes saving the company tax at 19%. Paying between the lower earnings limit and the primary threshold (£6,240 to £8,784 for 2020/21) has the added benefit that the year counts as a qualifying year for state pension and benefit purposes for zero contribution cost - something that is particularly valuable if the recipient does not have the 35 years needed for the full single-tier state pension.

The National Insurance employment allowance of up to £4,000 is available

National Insurance contributions are deemed to be paid at a notional zero rate on earnings between the lower earnings threshold and the primary threshold (£6,136 to £8,632 for 2019/20), allowing the recipient to benefit from a qualifying year for free.

Dividends must be paid in proportion to shareholding

- using an alphabet share structure enables dividends to be tailored to the circumstances of the recipient.

Taking advantage of the tax exemptions for certain benefits in kind, such as mobile phones, provides a further avenue for the tax efficient extraction of profits.

If the employment allowance is avail ab le (or the recipient is under 21), the optimal salary is equal to the personal allowance set at £12,500 for 2020/21. Although employee National Insurance contributions are payable at 12% on earnings above £8,784, the corporation tax deduction for the additional salary outweighs the NIC cost making it worthwhile.

Once the optimal salary has been paid and tax and/or employer's National Insurance are payable as well as employee's National Insurance, the payment of a salary is no longer tax efficient - the tax and/or National Insurance on the salary is more than the corporation tax saving.

Conventional wisdom is that further profits should now be extracted as dividends, as long as the company has sufficient profits from which to pay the dividends. The dividends will be tax-free to the extent that they are sheltered by the dividend allowance(set at £2,000 for 2020/21), and any remaining personal allowance. Thereafter they are taxed at the dividend rates, which at 7.5%, 32.5% and 38.1% are lower than the income tax rates (the actual percentage being dependent on director 's marginal tax rate).

Personal allowances of £2,000 per annum and £1,000 per annum are available for dividends and interest respectively

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Profits can also be extracted efficiently in the form of exempt benefits in kind, pension payments and rent for the use of a home office.

In a family company situation, paying a salary and/or dividends to family members to utilise their personal and dividend allowances and lower tax bands which would otherwise be wasted is beneficial. As always, the personal circumstances of the recipient should be taken into consideration.

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