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Extracting profits from a business

What are the tax implications?

People run businesses for a variety of reasons from passion to pride, but making a living is high up the list for most people.

How do you go about drawing profit from your business, and doing so efficiently?

If your business operates as a partnership or sole trader, the profits it makes are what you are taxed on, subject to any expenses which are not deductible for tax purposes.

It makes no difference to your tax bill whether the profits are held within the business or extracted for your personal use.

When you work through a limited company, the total tax paid by the company and the shareholders will depend on the methods used to extract profits from the company and the amount withdrawn.

This guide discusses some of the common ways in which you can extract profits from your own company. The tax rates and thresholds quoted apply to 2018/19.

Salary

Paying yourself a salary of between £6,032 and £8,424 for a full year counts towards the state pension and other state benefits, but neither you or your company have to pay any national insurance contributions (NICs).

Any salary above £8,424 would result in employer's NICs being payable at 13.8%.

Employees' NICs would be payable above this amount at 12% up to a limit of £46,384. Above this amount the rate of employees' NICs payable falls to 2%.

Your employer's NICs liability can be set against the £3,000 employment allowance, if your company employs more than just you as the sole director and pays each of those additional employees more than £8,424.

Employing a family member can be a good way to spread the income from the business around the family, and use all available personal allowances and lower tax bands.

However, the wage paid to a family member must represent a market rate for the work performed – you shouldn't pay your son a senior executive's salary if he's working on reception, for example.

Dividends

The company must have sufficient reserves before the directors authorise a dividend to be paid.

If there are insufficient reserves available, any dividends paid may be re-categorised as loans to the recipients.

Each individual is entitled to an annual dividend allowance of £2,000.

Dividends received up to this limit are taxed at 0%, while additional dividends are subject to dividend tax according to the tax band the income falls into:

Income tax band	Tax rate
Basic-rate taxpayer (up to £34,500)	7.5%
Higher-rate taxpayer (up to £150,000)	32.5%
Additional-rate taxpayer (more than £150,000)	38.1%

These tax bands can be expanded if you make pension contributions or gift aid donations out of net income.

Spreading dividend income among your family members can allow them to use their £2,000 dividend allowance, and pay no tax on that portion of their dividend income.

However, those family members need to first hold shares in the business which entitles them to receive the dividends.

92B King Street
Knutsford WA16 6ED Cheshire
01565-754333 mail@thehampartnership.co.uk

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You can give away shares to your spouse or civil partner with minimal tax implications, but seek advice before doing so.

To be effective for tax planning purposes the shares should carry a full quota of rights, including the right to vote, receive a variable dividend and share in the capital of the business on a winding up.

Shares given to employees can be subject to income tax as employment-related securities, but there's a general exemption from that legislation for gifts made as part of a family relationship.

As an alternative to giving shares, family members could subscribe directly for new shares to be issued by the business.

Pension contributions

Where the business pays pension contributions as your employer, those payments are tax deductible for the business, so long as your total remuneration package is reasonable for the work you perform for the company.

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.

If you've already taken some pension benefits, or your annual income is £150,000 or more, you may have a restricted annual allowance.

Seek expert advice before investing in a pension scheme.

Benefits-in-kind

You can take advantage of tax-free benefits up to the following limits:

- non-cash gifts up to £50 per item (see below)
- one mobile phone per employee
- loans worth up to £10,000 per person (see below)
- employer-provided training (no monetary limit).

The non-cash gifts can be items such as wine, flowers, chocolates, vouchers or a gift card, but it must not be given as a reward for services or be in any way contractual. Vouchers and gift cards must not be exchangeable for cash.

Company directors and their family members can receive up to £300 of tax-free gifts from the company in total per tax year.

Loans from the company

You can borrow money from your company, if this is permitted by the company's articles and by company law, but there are tax implications to consider.

Where the loan exceeds £10,000 at any point in the tax year, you will be taxed on deemed interest calculated at HMRC's official rate of interest, which is currently 2.5% of the total loan less any interest you actually pay. The company will also pay 13.8% NICs on that net deemed interest.

A loan of any value will generate a tax charge at 32.5% on any amount still outstanding more than nine months after the end of the accounting period in which the loan was advanced.

This tax is payable by the company, but it can be reclaimed once the loan is repaid subject to certain rules.

Where the loan repayments are made out of taxed income, the loan is not treated as a continuous loan.

Be aware that loans to an employee through a third party, such as an employment trust, may be categorised as disguised remuneration and be subject to PAYE and NICs as if the loan was salary.

Lending to the company

If your company owes you money, perhaps as undrawn dividends or salary, it can pay you interest on those funds at a commercial rate. Such interest is tax deductible for the company, if it uses the funds for business purposes.

You should draw up an agreement between yourself and the company to formalise the payment of interest, which sets the applicable interest rate and terms for the loan repayment.

The downside is the company must deduct 20% tax from the regular interest payments, report and pay those deductions to HMRC on form CT61 each quarter.

Where the total interest you receive in a year is less than your saving allowance (£1,000 or £500 for higher-paid individuals), you can reclaim the tax deducted through your tax return.

If your annual income exceeds £150,000 you are not entitled to a savings allowance.

In addition to the savings allowance, there's the starting savings rate which owner-managed businesses can take advantage of. This allows another £5,000 of interest tax-free where you earn less than £11,850 in 2018/19.

Rent

If you own a property which is used by the company for its trade, the company can pay you rent. The property can be anything from a factory to part of your own home and in every case, the terms of the arrangement should be set out in a lease or licence agreement.

Always seek legal advice on land-related agreements, and be careful not to give the company exclusive use of any part of your home, as this could restrict your capital gains tax exemption relating to that property.

The rent paid is tax-deductible for the company, and it does not attract NICs for you or the company.

You need to declare the rent on your tax return alongside any relevant expenses, such as insurance or mortgage interest. The £1,000 property income allowance cannot be set against rent received from your own company.

In the long-term, receiving rent for a commercial property can restrict the availability of entrepreneurs' relief on gains made on the eventual sale of that property.

Speak to us about extracting profits.