

Extracting company profits

Businesses that use a corporate structure have a distinct tax-edge over their self-employed competitors. In a nutshell, a company pays Corporation Tax (CT) on all its profits - no additional tax is payable unless the directors and/or shareholders withdraw the post CT profits for their own use.

Compare this to self-employed persons who pay Income Tax at variable rates - between 20% and 45% in England, Wales and Northern Ireland, and between 19% and 48% in Scotland - on all their profits, whether they leave the profits in the business or extract funds to finance personal expenditures.

This has led many profitable sole traders and partnerships to incorporate, especially when they want to retain post tax profits in their business. In some respects, this means that incorporated businesses have a competitive edge over their unincorporated rivals.

Director/shareholders of small companies also have more choice when it comes to the consideration of how they withdraw funds from their company for personal use.

What is the best way to extract funds from a company?

Shareholders, who are also directors, have a choice of five basic options:

- They can take a director's salary.
- They can sacrifice part of their salary in exchange for a limited range of tax-free benefits.
- Director/shareholders can take dividends based on their shareholding in the business.
- Directors who have loaned their company funds can charge interest to the company.
- If a director's company has the use of the director's personally owned assets, the director can charge their company a rent.

These options are now considered in more detail.

Taking a salary

For most of us, taking a salary involves both employer and employee paying a National Insurance Contribution (NIC), and the employee will also suffer a tax deduction under the PAYE regulations. At higher salary levels the combined NIC charges can be quite significant and for this reason, current tax strategy favours a low salary approach. Under present legislation, it is still acceptable to reduce salary levels to an amount that will secure rights to State Benefits and pensions, whilst keeping NIC charges to a minimum.

How, in that case, do director/shareholders take any balance of remuneration?



Tax-free benefits

Until the Finance Act 2017, there were a number of tax-free benefits (BiKs) that could be taken in lieu of salary. Since the change in legislation, many these perks are no longer available or have been phased out. The current position is as follows:

The Finance Act 2017 introduced a rule to value all BiKs at the higher of the cash forgone or the current taxable value. The following benefits are not affected by this rule:

- Employer provided pension saving;
- Employer provided pensions advice;
- Childcare Vouchers;
- Workplace nurseries;
- Directly contracted childcare;
- Cycle to work schemes;
- Ultra-Low Emission Vehicles emitting 75g CO2/km or less.

Thus far, we have concluded that a low salary approach is advisable and that the options for taking benefits in lieu of salary are being restricted. In which case, how should a director/shareholder make up their take-home pay? The answer is provided in the following section.



Dividends

If you own shares in a UK company, they are usually issued with the right to receive dividends. Dividends are treated as a distribution of your company's profits, after CT has been deducted. When voted or drawn dividends are taxed as income in the hands of the recipient. Dividend income has its own special tax rates dependent on where the dividend income sits in the various Income Tax bands. For 2024-25 the current rates payable are:

- The first £500 of dividends received suffer no further tax charge.
- If the dividends are part of your basic rate tax band they are taxed at 8.75%.
- If the dividends are part of your higher rate tax band they are taxed at 33.75%.
- If the dividends are part of your additional rate tax band they are taxed at 39.35%.

Please note, it is not possible to draw dividends in excess of the company's retained profits.

Interest on monies loaned to the company

If a director/shareholder is required to loan private funds to his company, for whatever period, it is possible for the director to be paid interest on the loan.

Obviously, the interest will form part of their taxable income but if the director has no other savings income, the first £1,000 of any interest paid (if the director is a standard rate taxpayer) or £500 (if the director is a higher rate taxpayer) is free of tax covered by the Personal Savings Allowance. Directors who pay tax at the additional rate will not qualify for this allowance.

Any interest paid in this way by a company will be an allowable deduction for CT purposes.

Receive a rent for personal assets used by the business

If rents paid to a director are based on commercially acceptable rates, then the cost to the company is fully deductible for CT purposes. Unlike salary and certain benefits, the receipt of rent from the company would not trigger a National Insurance charge.

Often, directors own the freehold of business property personally, and many do not charge their company a rent for the use of that property. Assessing a commercial rent and paying this on a regular basis to the director is a tax effective option. See further comments below.

What is the best overall extraction strategy?

Under present legislation, it would appear that a low salary, high dividend approach works best to maximise after tax income. BiKs should also be considered.

However, as dividends are a distribution after CT has been paid and are subject to the hybrid rates of tax if more than £1,000 a year, then rental income looks to be the most tax effective option for withdrawing funds from a company. Obviously, this strategy would only be available to individuals who have personal assets in use by their business.

Every persons' tax position is unique and should be planned for on a case by case basis. If you are considering your options for profit extraction from your company then please get in touch.



Summary action list

- Be sure to examine all your options. Every persons' personal tax circumstances are different.
- Dividend payments can only be taken if there are available reserves in the company.
- Take National Living Wage regulations into account, when you adopt a low salary high dividend approach and formalise arrangements.
- Planning in this area is complex and we recommend that you take professional advice before finalising your profit withdrawal options.

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