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Salary versus Dividends

& Other Tax Efficient Profit Extraction Strategies

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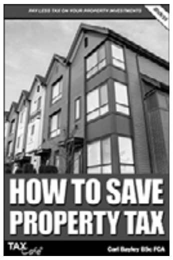

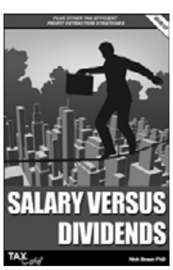

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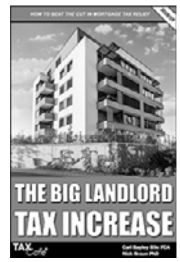

About the Author & Taxcafe

Dr Nick Braun founded Taxcafe in 1999, along with his partner Aileen Smith. As the driving force behind the company, their aim is to provide affordable plain-English tax information for private individuals, business owners and professional advisors.

Over the past 18 years Taxcafe has become one of the best-known tax publishers in the UK and has won several prestigious business awards.

Nick has been a specialist tax writer since 1989, first in South Africa, where he edited the monthly *Tax Breaks* publication, and since 1999 in the UK, where he has authored several tax books including *Landlord Interest*, *Small Business Tax Saving Tactics* and *Pension Magic*.

Nick also has a PhD in economics from the University of Glasgow, where he was awarded the prestigious William Glen scholarship and later became a Research Fellow.

Contents

Introduction

This guide answers the most common question asked by company owners: "What's the best way to take money out of my company if I want to pay less tax?"

In Part 1 we kick off with a plain English guide to how *companies* are taxed. We explain how corporation tax is calculated and why companies are such powerful tax shelters.

We then explain how *company owners* are taxed. As a director/shareholder you can choose the best <u>mix</u> of salary and dividends. We examine the pros and cons of each type of income.

Company owners can also choose the most tax efficient <u>level</u> of income.

We explain how by smoothing your income, or varying it significantly from year to year, you may be able to cut your tax bill considerably.

Tax-Free Salaries & Dividends

In Part 2 we reveal how much tax-free salary and dividend income you can withdraw from your company this year.

You'll discover how to calculate the "optimal" tax–free salary and how couples in business together can pay themselves £27,700 tax free this year.

In Part 3 we explain how much dividend income you can take taxed at just 7.5% and how to avoid paying tax at 32.5%.

This part of the guide also contains important tax saving strategies for parents who want to avoid the child benefit tax charge.

This kicks in when your income exceeds £50,000 but many company owners will be able to avoid it completely or in part.

There is also important tax planning information for high income earners (those with income over £100,000 or £150,000).

Income from Other Sources

In Part 4 we turn to company owners who have significant amounts of income from other sources (e.g. rental income, interest income, income from another business and stock market dividends).

We explain why you may need to adjust your company salary or dividends to avoid the higher tax rates that kick in when your income reaches certain key thresholds (£46,350, £50,000, £100,000 and £150,000).

We also examine some tax planning techniques that can be used to reduce or eliminate the tax payable on your income from other sources.

Company owners who are also landlords need to be aware of the new restriction to tax relief on mortgage interest. Fortunately, company owners have more flexibility than other landlords when it comes to avoiding some of the worst effects of this tax change.

Company owners can also enjoy much more tax-free interest than other taxpayers (up to £6,000 per year). Additional tax savings can be enjoyed by allocating some of your personal allowance from your interest income to your dividend income.

Splitting Income with Family Members

Part 5 explains how company owners can gift shares in the business to their spouses, partners or children and save up to £12,626 in tax this year, with similar savings every year.

We also show how additional savings can be achieved by paying tax-free salaries to family members (including minor children).

There are, however, many traps to avoid when it comes to splitting income with family members and these are fully covered in this part of the guide.

For example, we examine the danger of gifting shares that have fewer rights than ordinary shares and the danger of using dividend waivers to divert income to your spouse.

Alternative Profit Extraction Strategies

Part 6 looks at alternative profit extraction strategies:

- **Directors' loans** – How they can be used to reduce or postpone tax.
- **Rent** – Why getting your company to pay you rent is now more tax efficient than a dividend in many circumstances.
- **Interest** – How to receive up to £6,000 of tax-free interest from your company.
- **Charity** – Who should donate: you or the company?
- **Pension contributions** – Why they're better than dividends, who should make them (you or the company), plus a new chapter on putting property into a pension.
- **Company Cars, Vans & Motoring Costs** – a Plain English guide to the tax rules.
- **Mobile Phones** – Getting your company to pay the cost.
- **Capital gains** – How to pay 10% tax when you sell or wind up your company; How to pay 0% tax when you sell your company to an employee ownership trust.

In Part 7 we turn to some of the practical issues and dangers that may be experienced when extracting money from your company:

- How to avoid the minimum wage regulations
- How to make sure your salary is a tax deductible expense
- Making sure your company has sufficient distributable profits to declare dividends
- How to declare dividends properly and avoid an HMRC challenge
- The circumstances in which HMRC may try to tax your dividends as earnings

Other Tax Saving Strategies

In Part 8 we show how company owners, by altering the amount of income they withdraw from their companies, can reduce the amount of capital gains tax payable when assets like rental properties are sold.

The penultimate chapter of the guide explains how you may be able to completely avoid tax by emigrating, including details of the statutory residence test.

Finally, the last chapter explains how you can reduce your income tax bill by investing in venture capital trusts.

Using This Guide & Limitations

This tax guide deals primarily with the 2018/19 tax year, starting on 6 April 2018 and finishing on 5 April 2019.

There are references to other tax years, for example when discussing the advantages and disadvantages of postponing income to a future tax year.

However, it is important to emphasise that the tax rates and tax laws that will apply in future tax years are not known with any degree of certainty.

Tax rates and tax laws (including HMRC's interpretation of those laws) are continually changing. The reader must bear this in mind when reading this guide.

Please note that, although owners of small trading companies are this book's main target audience, this is NOT supposed to be a do-it-yourself (DIY) tax planning guide.

My purpose in writing this guide is to explain in plain English how companies and company owners are taxed and provide some tax planning ideas that can be taken to an accountant or other professional advisor for further discussion.

I do not recommend 'going it alone' when it comes to this type tax planning and there are several reasons for my cautious approach.

Firstly, although the guide covers a fair amount of ground, it does not cover every possible scenario – that would be impossible without making the guide much longer and possibly much more difficult to digest.

In other words, in places I have had to sacrifice definitiveness in favour of making the guide a manageable and hopefully enjoyable read for the average small company owner.

Companies come in many different shapes and sizes, as do their owners, so it is possible that the information contained in this guide will not be relevant to your circumstances.

In particular, please note that this guide is aimed mainly at UK resident director/shareholders who own and work for UK resident companies.

Secondly, the main focus of this tax guide is *income tax* planning: helping company owners pay less tax on their salaries, dividends and other income. There are, however, other taxes that often have to be considered, including capital gains tax and inheritance tax.

Steps that you take to reduce one type of tax can have an adverse impact on your liability to pay other taxes. While some mention is made of other taxes in this guide, I cannot guarantee that all interactions are covered.

Thirdly, there are potential risks involved when it comes to structuring your affairs to reduce the tax payable on salaries, dividends and other payments made by your company.

While most of the tax planning ideas contained in this book are widely used by many accountants and other professional advisers, and have been for many years, this does not mean they have the blessing of HM Revenue & Customs!

There are lots of grey areas when it comes to this area of tax planning and there are no guaranteed tax savings.

In other words, we cannot be certain that some of the tax planning ideas contained in this book will not be subject to some sort of attack from HMRC, even if only at some point in the future.

For example, in the chapters that follow we will show that the most tax-efficient mix of income for most company owners is a small salary coupled with a larger dividend. While this may be the *mathematically* optimal income mix for many company owners, the tax savings are not guaranteed.

There is a danger that HMRC will seek to tax dividends as earnings in some circumstances and may frown on any reduction in an existing salary – see Chapters 35 and 36 for more information.

Fourthly, there are also *non-tax* factors that have to be considered when deciding how much money you withdraw from your company and in what form. In some instances other considerations will outweigh any potential tax savings.

For all of these reasons it is vital that you obtain professional advice before taking any action based on information contained in this guide. The author and Taxcafe UK Ltd cannot accept any responsibility for any loss which may arise as a consequence of any action taken, or any decision to refrain from taking action, as a result of reading this guide

The General Anti-Abuse Rule

A new general anti-abuse rule (GAAR) came into operation on 17 July 2013.

Tax arrangements are "abusive" if they cannot reasonably be regarded as a reasonable course of action – this is commonly referred to as the double reasonableness test.

Clearly it's very subjective and HMRC has sought to reassure taxpayers that there will be a "high threshold" for showing that tax arrangements are abusive:

"In respect of any particular arrangement there might be a range of views as to whether it was a reasonable course of action: it is possible that there could be a reasonably held view that the tax arrangements were a reasonable course of action, and also a reasonably held view that the arrangement is not a reasonable course of action. In such circumstances the tax arrangements will not be abusive for the purposes of the GAAR."

An indicator that tax arrangements may not be abusive is if they were "established practice" when entered into and HMRC indicated its acceptance of that practice at the time.

Tax arrangements may be abusive if, for example, the tax result is different to the real economic result, for example tax deductions or tax losses that are significantly greater than actual expenses or real economic losses.

If you think that all of the above is a bit vague and subjective, you are not alone. Even the best tax brains in the land don't know what this test means in practice. When legislation contains words like “reasonable” and “abusive” you know you have to be on your guard!

The question being asked by some tax advisers is this: will the anti-abuse rule be used to attack the sort of ‘normal’ or ‘mainstream’ tax planning carried out by thousands of small company owners, for example taking small salaries and dividends?

Many tax experts believe that well-established, conventional tax planning will not be attacked by HMRC using the GAAR. Instead the focus will be on the extreme end, for example ‘aggressive’ or ‘artificial’ tax avoidance schemes.

This view seems to be backed up by HMRC guidance published in January 2015 which says the following about small company dividends:

“Just as it is essential to understand what the GAAR is targeted at, so it is equally essential to understand what it is not targeted at. To take an obvious example, a taxpayer deciding to carry on a trade can do so either as a sole trader or through a limited company whose shares he or she owns and where he or she works as an employee. Such a choice is completely outside the target area of the GAAR, and once such a company starts to earn profits a decision to accumulate most of the profits to be paid out in the future by way of dividend, rather than immediately paying a larger salary, is again something that should in any normal trading circumstances be outside the target area of the GAAR.”

Nevertheless, at present the simple truth is that no one knows how HMRC will apply the general anti-abuse rule to company owners in the years ahead and whether it will eventually affect certain tax planning practices that many regard as mainstream, including some of those contained in this guide.

Scottish Taxpayers

The Scottish Parliament now has the power to tax most types of income. The vast majority of the information contained in this guide is relevant to Scottish taxpayers and there is quite a lot of information specific to them. However, unless stated to the contrary, all examples, tables and calculations assume that the taxpayer concerned is not a Scottish taxpayer.

Part 1

How Companies & Company Owners Are Taxed

Chapter 1

How Companies Are Taxed

Companies generally pay corporation tax on both their income and capital gains.

For the current financial year, which starts on 1 April 2018, all companies (except some in the oil and gas sector) pay corporation tax at the same flat rate of 19%.

The rate was previously 20%.

Things weren't always this simple. There used to be two headline corporation tax rates: a higher rate for companies with profits over £1.5 million (known as the 'main rate') and a lower rate for companies with profits under £300,000 (the 'small profits rate').

There was also a third rate applying to profits between £300,000 and £1.5 million.

Not only has corporation tax become a lot simpler, it has also been significantly reduced, as the Government has tried to boost the UK as a business destination. Back in 2007 the main rate was 30%.

Smaller companies haven't enjoyed such significant tax cuts, although it must be remembered that the small profits rate was due to rise to 22% back in 2011.

Both big and small companies do, however, benefit from the recent cut in the corporation tax rate from 20% to 19% which took place on 1 April 2017.

The rate will be cut again to 17% on 1 April 2020.

Most small company owners will welcome these cuts because they will partly offset increases in the tax paid on the dividends they withdraw from their companies.

Northern Ireland

In Northern Ireland the rate may be cut to 12.5% when corporation tax powers are eventually devolved to the Northern Ireland Assembly.

This would bring Northern Irish companies in line with those in the Republic, potentially making Northern Ireland a tax haven within the UK.

Corporation tax powers were originally expected to be transferred from April 2018 but the introduction has been postponed following the collapse of the Northern Ireland Government.

In the November 2017 Budget the UK Government stated that it *"remains committed to the commencement of a Northern Ireland rate of corporation tax once a restored Executive has demonstrated that its finances are on a sustainable footing. Subject to this, the Government will consider an announcement in 2018/19 on implementing the regime."*

So which companies/activities will qualify for the special tax rate when it is introduced?

The special corporation tax rate will apply to *trading* profits only. Other types of income, including investment income and property rental income, will be subject to the UK main rate of corporation tax, as will capital gains.

Micro, small or medium-sized enterprises (SMEs) will pay tax at the special rate on all their trading profits if they qualify as a 'Northern Ireland employer', i.e. if at least 75% of their staff time and costs relate to work carried out in Northern Ireland.

SMEs are currently defined under EU regulations as businesses with fewer than 250 employees and turnover of less than €50 million or a balance sheet total of less than €43 million.

Larger companies, with activity in both Northern Ireland and the rest of the UK, will have to treat their Northern Ireland trading activity as a separate business and allocate profits appropriately. The special rate will apply to profits that relate to the Northern Ireland trading presence, defined as a 'Northern Ireland regional establishment' (generally speaking a fixed place of business).

Legislation has been introduced to allow SMEs which do not qualify as Northern Irish employers, but do have a Northern Ireland regional establishment, to elect to use the large company rules to identify profits to which the Northern Irish tax rate applies. Otherwise they would not be able to benefit from the lower rate.

Look through Taxation Quashed

In 2016 the Orwellian "Office of Tax Simplification" (OTS) investigated a system of "look through" taxation for certain small companies.

A look through system, if made compulsory, would take away the tax benefits of using a company. Under look through taxation, instead of paying corporation tax, the affected company owners would pay income tax and national insurance on all the profits of the business, just like sole traders and partnerships do.

The advantage of using a company is that you can smooth your income and control your income tax bill by paying yourself dividends as and when you like.

Furthermore, those who wish to grow their businesses or protect themselves from a downturn can retain profits inside the company, in which case the only tax payable is 19% corporation tax (falling to 17% in 2020).

Fortunately, the OTS has decided not to recommend look through taxation because it would not simplify the tax system and harm investment. For now this specific threat has gone away.

Multiple Companies

Business owners used to be punished for owning more than one company. This is no longer the case (since April 2015).

What happened was the £300,000 small profit band (where the lower corporation tax rate was payable) had to be divided up among 'associated companies'.

For example, in the case of two companies, each company would start paying corporation tax at the higher rate when its profits exceeded £150,000 (instead of £300,000).

The associated company rules prevented the profits of one business being artificially spread over more than one company to avoid the higher rates of corporation tax.

The associated company rules have become largely redundant with the introduction of the single flat rate of corporation tax for all companies.

Nowadays you aren't penalised for owning more than one company – they all pay tax at the same rate (currently 19%).

There are many reasons why you may wish to own more than one company. For example, someone who owns an ecommerce business and a restaurant chain may wish to keep them separate so that each company can be sold more easily in the future.

Someone who owns a software company and a property rental business may wish to keep them in separate companies so that the 'trading' business (the software company) is not contaminated by the 'non-trading' business (the property rental business).

Companies that own too many non-trading assets, like rental property, can lose important tax reliefs, including Entrepreneurs Relief, Holdover Relief and Business Property Relief.

Example

Maz owns an insurance broker called Insure Clever Ltd. The company makes profits of £200,000 per year. Maz recently inherited £500,000 and decides to buy some rental properties. He works out that he will be better off investing through a company instead of personally and sets up a second company called Clever Property Ltd (see the Taxcafe guide Using a Property Company to Save Tax *for a full discussion of this topic).*

Before April 2015, Maz would have been penalized for owning two companies. Insure Clever Ltd's small profit band would have been reduced from £300,000 to £150,000 and the company would have paid corporation tax at the higher rate on £50,000 of its profits.

But if instead Maz decided to stick with one company and use Insure Clever to buy the properties, it's possible he would have lost his entitlement to various tax reliefs like Entrepreneurs Relief.

Now, however, Maz can keep his insurance and rental property interests separate without suffering a higher corporation tax bill. Both companies will pay 19% tax on all their profits.

Although the associated company rules are no longer relevant when it comes to determining the corporation tax rate your companies pay, they're still relevant for other purposes, for example in deciding whether a company has to pay corporation tax in quarterly instalments. Instalments are generally payable by companies whose profits exceed £1.5 million but this amount is divided up if there are any associated companies.

Whereas small companies currently only have to pay their corporation tax nine months after the financial year has ended, companies subject to instalments have to start paying tax half way through the year.

The associated company rules have also been simplified with effect from 1 April 2015. From this date a new '51% group test' applies.

For example, if a company owns 51% of the share capital of three subsidiaries, all four companies will be associated. The £1.5 million profit limit would then be divided by four to determine whether each company has to pay corporation tax in instalments.

In the past the fact that Maz owns 100% of both Insure Clever Ltd and Clever Property Ltd would have meant that the companies were associated.

However, under the new rules the fact that the ownership link is an individual doesn't count, i.e. the companies are not associated.

So some companies which previously were subject to the quarterly instalment regime may now find themselves outside it.

Trading Companies vs Investment Companies

In tax jargon a 'trading' company is one involved in, for want of a better word, 'regular' business activities, e.g. a company that sells goods online, a catering company or a firm of garden landscapers.

Common types of *non-trading* company include those that hold substantial investments in property or financial securities or earn substantial royalty income.

Corporation Tax

A few years ago, if your company was engaged mainly in non-trading activities it would have been punished with a higher corporation tax rate.

This is because a company classed as a close investment holding company (CIC) was not able to benefit from the small profits rate. It was forced to pay corporation tax at the main rate on all of its profits.

For example, if you set up a company to buy and sell stock market shares, a few years ago it would have been taxed at 30% (the main rate of corporation tax), even if it only made a small amount of profit.

Companies that own rental property were always excluded from the CIC provisions and were allowed to enjoy the small profits rate.

All this is no longer relevant because since April 2015 all companies, both trading companies and investment companies, pay corporation tax at the same flat rate, currently 19%.

Capital Gains Tax

If a company has too many non-trading activities (including most property investment and property letting) it may lose its trading status for capital gains tax purposes.

This will result in the loss of two important CGT reliefs:

- Entrepreneurs Relief
- Holdover Relief

Entrepreneurs Relief allows you to pay capital gains tax at just 10% (instead of 20%) when you sell your company or wind it up.

Holdover Relief allows you to give shares in the business to your children, common-law spouse and other individuals and postpone CGT. (You don't need Holdover Relief to transfer shares to your spouse because such transfers are always exempt.)

A company will only lose its trading status for CGT purposes if it has 'substantial' non-trading activities. Unfortunately to HMRC 'substantial' means as little as 20% of various measures such as:

- Assets
- Turnover
- Expenses
- Profits
- Directors' and employees' time

HMRC may attempt to apply the 20% rule to *any* of the above measures.

Inheritance Tax

Shares in trading companies generally qualify for business property relief which means they can be passed on free from inheritance tax. However, if the company holds investments (including rental property) this could result in the loss of business property relief.

The qualification criteria are, however, more generous than for CGT purposes and a company generally only loses its trading status for inheritance tax purposes if it is 'wholly or mainly' involved in investment related activities.

To be on the safe side you may want to ensure that the company's qualifying activities exceed 50% of each of the measures listed above (e.g. turnover, time, profits etc).

For more information see our guide *How to Save Inheritance Tax*.

Accounting Periods vs Financial Years

A company's own tax year (also known as its 'accounting period') may end on any date, for example 31 December, 31 March etc.

Corporation tax, on the other hand, is calculated according to financial years. Financial years run from 1 April to 31 March. The 2018 financial year is the year starting on 1 April 2018 and ending on 31 March 2019.

This matters when it comes to calculating how much tax your company will pay if the corporation tax rate has changed.

For example, on 1 April 2017 the corporation tax rate fell from 20% to 19%. A company whose accounting period ran from, say, January 2017 to December 2017 will therefore pay corporation tax as follows:

- 3 months to 31 March 2017 20%
- 9 months to 31 December 2017 19%

The practical effect is that the company pays 20% corporation tax on approximately one quarter of its profits and 19% tax on three quarters of its profits. (It doesn't matter at what point during the financial year the profits are actually made.) This means the company's *effective* corporation tax rate is 19.25%.

For the same company's current accounting period, which started on 1 January 2018 and ends on 31 December 2018, it will simply pay 19% corporation tax on all of its profits.

Then on 1 April 2020 the corporation tax rate will fall from 19% to 17%. For the accounting period which runs from January 2020 to December 2020 the company will pay corporation tax as follows:

- 3 months to 31 March 2020 19%
- 9 months to 31 December 2020 17%

The company will pay 19% corporation tax on approximately one quarter of its profits and 17% tax on three quarters of its profits. This means the company's *effective* corporation tax rate for that year will be 17.5%.

Please note, in most of the corporation tax calculations in this guide we use the current headline 19% rate, for example when calculating the corporation tax relief on salaries or company pension contributions. We also assume that all dividends are paid out of profits that have been taxed at 19%. This is to keep things simple.

Making Tax Digital (MTD)

The Government is considering making painful changes to the way businesses must operate, including compulsory digital record-keeping and, worst of all, quarterly reporting of results to HMRC.

Fortunately, the whole timetable for this farce has been moved back. Businesses will not be forced to use the Making Tax Digital system until April 2019 and then only to meet their VAT obligations.

VAT-registered businesses will have to keep their records digitally and provide their VAT return information to HMRC through Making Tax Digital compatible software.

The Government will not widen the scope of Making Tax Digital beyond VAT until the system has been shown to work, and not before April 2020 at the earliest.

At this stage it is difficult to predict what MTD will eventually look like for other taxes and who will be required to operate it.

Companies as Tax Shelters

This guide shows company owners how to extract money from their companies in the most tax efficient manner possible. However, before progressing to the various profit extraction strategies it is worth reiterating why it may be advantageous to use a company in the first place.

TABLE 1
Self-Employed vs Corporation Tax 2018/19

Profits	Self Employed	Company	Saving
£10,000	£295	£1,900	-£1,605
£20,000	£2,825	£3,800	-£975
£30,000	£5,725	£5,700	£25
£40,000	£8,625	£7,600	£1,025
£50,000	£12,000	£9,500	£2,500
£60,000	£16,200	£11,400	£4,800
£70,000	£20,400	£13,300	£7,100
£80,000	£24,600	£15,200	£9,400
£90,000	£28,800	£17,100	£11,700
£100,000	£33,000	£19,000	£14,000

Table 1 compares the total income tax and national insurance paid by self-employed business owners with the corporation tax paid by companies. Self-employed business owners in Scotland will pay even more income tax at most of the above profit levels (see Chapter 2 for a discussion of Scottish income tax rates).

Clearly companies don't always pay less tax than self-employed business owners, especially when profits are small. However, as profits increase so do the tax savings.

A business owner who uses a company will potentially have far more after-tax profit left to reinvest and grow the business. It is in these circumstances – when profits are reinvested – that companies are normally most powerful as tax shelters.

Profit Extraction = Additional Tax?

Table 1 may be misleading because it doesn't include the tax paid on any income extracted by the company owner.

Most company owners need to extract money for their own personal use. At this point an additional income tax and national insurance charge may arise.

The good news is that by carefully structuring your pay it is possible to minimise these additional tax charges. That's what this guide is all about!

However, it's worth making one final point. Following the recent increase in dividend tax rates, many company owners now pay more tax than self-employed business owners, sometimes *a lot* more tax.

For more information see the Taxcafe guide *Using a Company to Save Tax* which examines the pros and cons of being self employed with the pros and cons of using a company.