Wealth Extraction Strategies

About us
We are a city firm registered with ICAEW who have worked with startups to AIM Listed plcs to multinational £150m+ businesses in a variety of sectors from manufacturing to online gaming. Visit our website at **www.mah.uk.com**.

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Abbreviations
ICT Income Tax
NI National Insurance contributions

Contents

1) Introduction
Taxation has been woven into the fabric of our society since the first city states flourished in Ancient Sumer. Ostensibly levied to pay for war, administering states or empires and more recently the welfare state, schemes have ranged from taxing the production of crops to the number of windows in a house to income tax as we know it today.

Whilst salaried workers can often do nothing about their ICT/NI liabilities, and may sometimes feel like modern day serfs, business owners can exercise choice to take advantage of their legal right to minimise their tax bill.

This document aims to elucidate the wealth extraction choices from a limited company and also to illustrate the common pitfalls that should be avoided. Whilst an abundance of information has already been published on this topic, its dispersed in nature and is more knowledge, rather than application.

2) Salary

Form of remuneration

Salary or remuneration compensates a director for providing his/her time, skills and services to the company, or to hold an office.

The basic salary is likely to be contracted for on an annual basis, although the amount payable each month could vary according to time spent. Having a signed contract makes it much easier to justify accruals for services paid for in later years. In early stages of the business, the director could also choose to waive the salary.

There may also be bonuses. Although these could be performance related per contract, these are more likely to be discretionary in owner manager businesses.

Taxation of salary

Salary has to be accounted for via the payroll under the PAYE scheme (Pay As You Earn) with ICT and both employees and employers NI calculated on the gross salary. The key rates are:

	£ limits	**Rate**
Income Tax		
Basic rate	7,475 – 42,475	20%
Higher rate	42,475 – 150,000	40%
Additional rate	150,000+	50%
Employees NI		
Primary Threshold	7,228 – 42,484	12%
Above Upper Earnings Limit	42,484+	2%
Employers NI		
Secondary Threshold	7,072+	13.8%

(personal allowance disappears gradually between £100k-115k)

HMRC must normally be paid the ICT & NI by the 19th of the following month. Note that if a salary or bonus is accrued but not actually paid, HMRC would view the accrual as deemed to be paid and so the ICT & NI may still have to be accounted for and paid.

Salary reduces corporation tax

The gross salary/bonus and employer's NI will be a tax deductible expense for the company, reducing their corporation tax bill. The company will get tax relief for a particular year if the bonus is paid within 9 months of the year end. For example, a bonus accrued on 31/12/10 is paid by 30/09/11.

This brings us to a common problem which is that discretionary bonuses are often only thought about long after the year end and are only accrued for after the draft accounts have been prepared.

Using the above example, from an accounting point of view, a board resolution dated as at 31/12/10 authorising the bonus would be sufficient to provide for the bonus & employers NI. Potentially, HMRC could dispute this if the bonus was not included in the December 2010 payroll and PAYE calculations and therefore claim that it wasn't deemed as paid, thereby preventing a tax deduction for the bonus in year ended 31/12/10.

3)Dividends

How dividends work

If a company generates a profit, it suffers corporation tax first, and then whatever profits are left are added to retained earnings.

Dividends are distributions to shareholders out of the company's retained earnings. The shareholder has invested capital in to the company and is entitled to a share of the profits after tax, generated by that investment. A shareholder may also be a director.

Taxation of dividends

Dividend income is taxed under the Self Assessment process so a shareholder needs to include it in their tax return. The key rates are:

Income Tax	£ limits	Rate	Effective rate after deemed 10% tax credit
Basic rate	7,475 – 42,475	10.0%	nil%
Higher rate	42,475 – 150,000	32.5%	25.0%
Additional rate	150,000+	42.5%	36.1%

The headline rates don't include the deemed 10% tax credit, so this is taken into account when calculating the effective rate.

Legal & paperwork requirements

A key point is that dividends cannot be paid unless there are sufficient retained profits. The board needs to consider up to date management accounts and check that the company has sufficient profits to pay the proposed dividends, otherwise they could be illegal.

Dividends need to be declared by the board and it is important to have the proper paperwork at the right time. So the company needs to have a board resolution and dividend minute to declare the dividend for it to be an obligation. So the dividend strategy needs to be considered both at the company's year end and before 5 April for the tax financial year.
If the dividends are not properly authorised or are illegal, they may be subject to NI.

Dividends and proportion of shares held

Dividends are paid in proportion to the number of shares held. For example, if a company is owned by shareholders 30:70 split, then the dividends are paid in the same proportion.

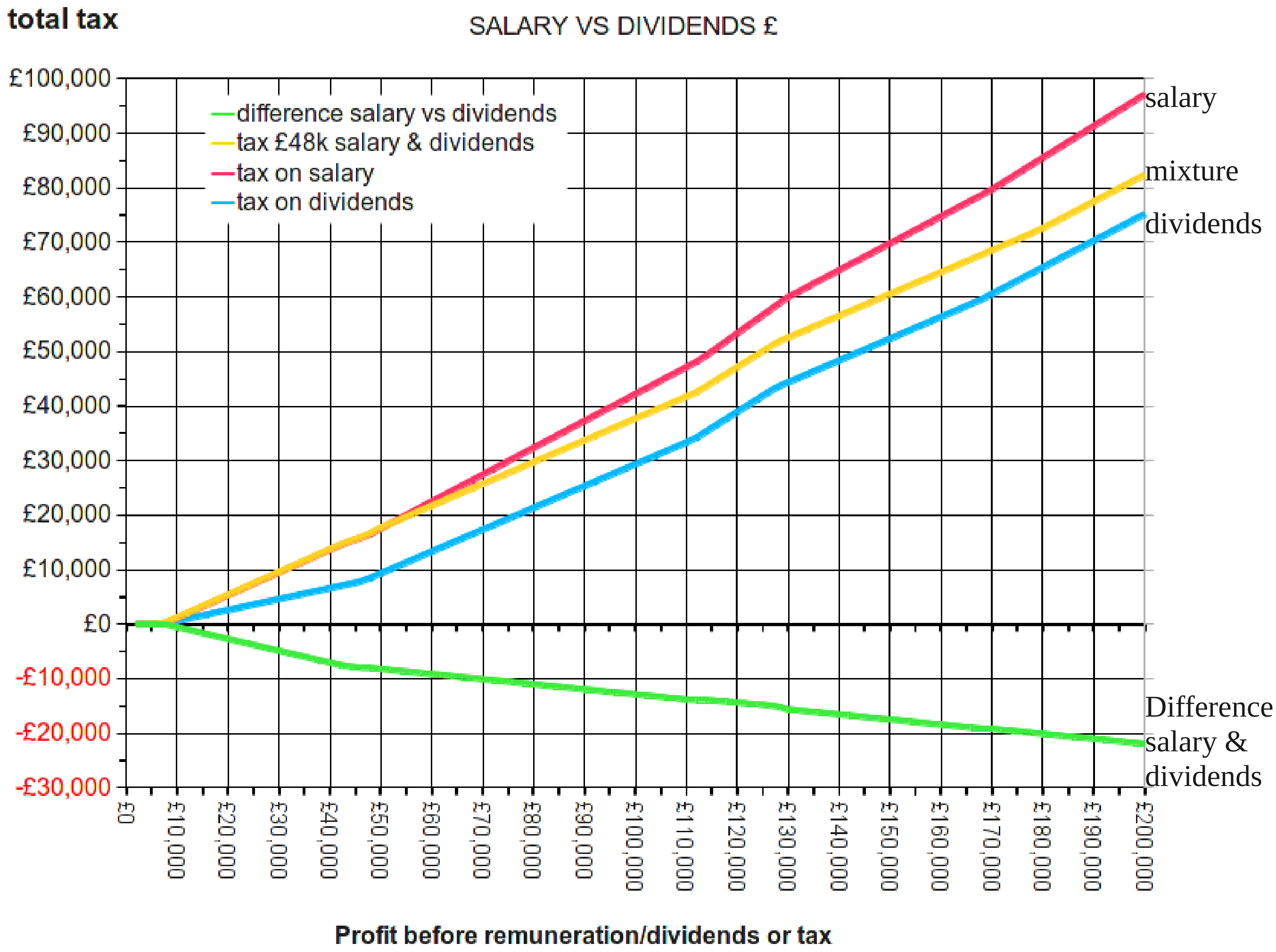
However, its possible to create different share classes e.g. A shares and B shares to declare 2 completely separate sets of dividends, therefore can pay dividends in any proportion and not be restricted by the actual percentage of shares held.

This can be a key problem area as there is a temptation to shift income to a spouse by gifting shares in a separate class without voting/capital rights, and therefore pay dividends, without risk of board disputes/ownership issues in case of divorce. But under settlements legislation, these shares would be seen as a right to income only, and therefore HMRC would prevent the income being allocated to the spouse, so their tax free allowance etc couldn't be utilised.

4) Comparison of salary vs dividends

From the graph* we can see that at all levels, salary (red line) is a more expensive method of extracting wealth out of the business than using dividends (blue line).

The green line shows the tax saving if dividends are used instead and we can see that the absolute saving gets bigger as profits increase. A business with 100k profits would pay £13k more in tax using salary instead of dividends.

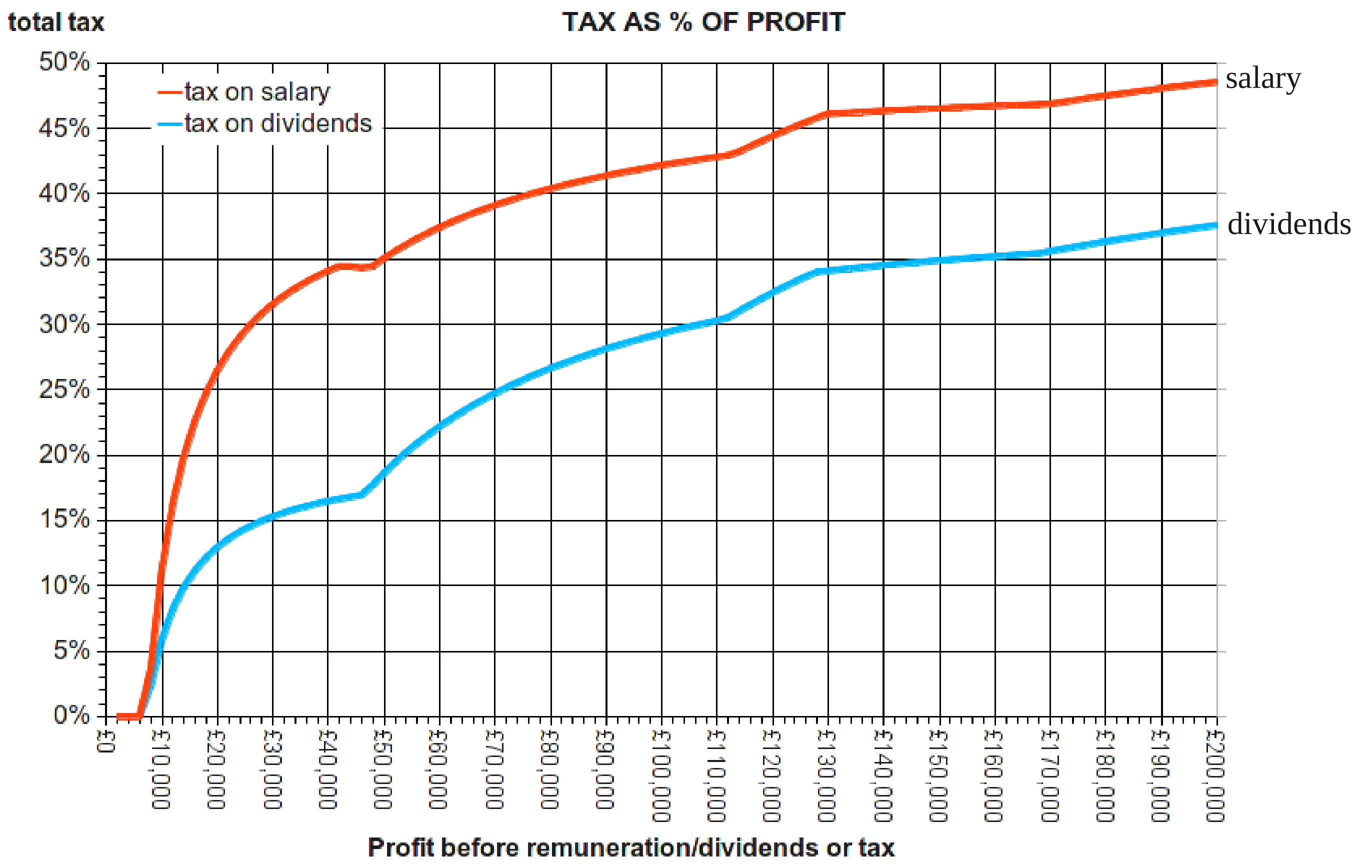


Whilst the substitution of dividends for remuneration isn't technically an abnormal practice, this can sometimes make HMRC curious. To try and lower the risk of HMRC enquiries, many companies will pay a “living wage” to cover mortgage and expenses. For example, paying a mixture of £45K salary and dividends (yellow line) results in approximately a £8k tax difference to salaries.

Salary is more tax expensive than dividends primarily due to national insurance contributions, which are not payable when using dividends.

This offsets the fact that dividends are not tax deductible and corporation tax has to be paid on the profits first. The income tax rates for dividends are also lower due to the deemed tax credit.

The next graph shows how the difference is more pronounced at lower levels as we can see that from £20k to £50k the tax paid as a proportion of profits is nearly double for salary compared to dividends. The difference in proportions then narrows to approximately 12% which is still significant.



<u>*Notes on graphs</u>

To illustrate salary vs dividends we have calculated the income tax, national insurance contributions and corporation tax as applicable, and factored in reduction in personal allowance from £100k. The dividends method actually includes £7k of salary as well to obtain the tax shield whilst utilising the personal allowance. Both methods assume that all profit is distributed and none is retained for future. The salary method splits profits between salary and e'ers NI. The lines are kinked due to changes in the tax rates and the first £7k is tax free due to the personal allowance.

5) Capital route

Rather than extracting large amounts of profits from the business, they could be re-invested to increase the value of the business in the long term.

On exit, the shares would be sold at a profit and this would give rise to a chargeable gain. However, if the criteria for Entrepreneurs Relief are met, the first £10m of such gains in a lifetime would be taxed at 10%. This is much lower than either salary or dividends, although there would be uncertainty over the future development of the business and whether a successful exit could be achieved.

The key criteria for Entrepreneurs Relief are:

1) owned at least 5% of shares giving 5% of voting rights of the business for 1 year
2) business is trading (or holding co. of trading group)
3) must be either an officer or employee of the company.

Note that this requires a genuine disposal transaction with a commercial justification. Therefore, a share buyback wouldn't normally qualify unless a shareholder was substantially relinquishing influence etc. Such a share buyback may be treated as an income distribution and taxed similar to dividends.

6) Director's loan

Companies Act 2006 removed the general ban on director loans, provided prior approval has been obtained from shareholders e.g. a written resolution.

If a director takes a loan and its not paid back within 9 months of the year end, s.455 tax of 25% of the loan balance becomes payable.

The director will also have received a benefit if there is no interest charged, or it is below the commercial rate. Therefore this difference has to be declared as a P11d benefit (see “benefits” below).

However, there is no beneficial loan charge if its below £5k at any time.

A common pitfall is that the director's loan balance is only identified once the accounts have been prepared and it will be settled using bonus or salaries. However, HMRC will view the loan as settled when the bonus/salary is actually paid or deemed to be paid i.e. the time at which its processed in payroll and tax/NI is calculated and becomes payable to HMRC. Therefore, couldn't suddenly decide in September 2011 that a bonus was due to the director as at December 2010 for director's loan purposes.

If a director's loan is written off it'll be taxable as dividend income for income tax purposes and is also likely to attract class 1 NI, so this wouldn't be very efficient.

An extreme example of a director's loan to extract wealth could potentially be to perpetually make loans to the director every December, who would physically repay shortly before the 9 month limit each year using another temporary loan from the company every August:

	Date	Loan b/fwd	movement	loan c/fwd
new loan	31/12/11	0	100	100
temp loan	08/08/12	100	100	200
repay 2011	30/09/12	200	(100)	100
new loan	31/12/12	100	100	200
temp loan	08/08/13	200	200	400
repay 2012	30/09/13	400	(200)	200

However, if no cash changed hands, HMRC would argue that the loan hasn't actually been repaid and the book entries don't reflect the actual underlying transactions.

HMRC could also try to argue that the temporary physical cash transactions in August/September are a series of linked transactions without a commercial purpose and so may ignore them for tax purposes. Although this may be difficult if there are lots of loan movements in and out.

7) Benefits

Another method to extract wealth is by way of non-cash benefits such as health insurance, company cars or accommodation. The assessable cost of these would be included in the P11d and there would be employer's NI at 13.8% Class 1A for the company, and the director would have to add it to their income for income tax. The actual cost of the benefit would also be an allowable deduction for the company against corporation tax.

So could potentially save on employee's NI compared to salary.

However, the assessable benefit is not always straightforward to calculate and the method varies depending on the benefit. So would need to check the calculations individually to ascertain the tax efficiency of a particular benefit.

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8) Management fees

overseas

If directors or shareholders are domiciled overseas it may be possible to shift income by paying management fees to an overseas company in a low tax jurisdiction.

Any overseas company would also need to be managed and controlled overseas. Note that this could involve board meetings being held overseas, and HMRC could ask for passport stamps etc.

The management fees would also have to be justified, for example HMRC could ask to see email/call logs to prove the services offered, and how these differed to normal director's office duties. Transfer pricing rules may also need to be complied with.

However, this area would need to be carefully looked at to ensure that the management fees didn't involve compensation of an office held by the director as this could possibly be classed as an emolument and subjected to NI.

Could also use an offshore company to be the lease/freeholder and charge the company rent.

UK

Also, if there was a UK loss making company, fees could be paid to them or use recharges with a mark up for services provided, if justifiable.

9) Pensions

This is a complicated area and there are many other investment considerations to be made when planning for retirement. However, from a tax perspective in terms of wealth extraction, pensions could be highly tax efficient as a director could obtain tax relief at the full marginal rate on contributions up to £50k. Although, need to include any employer contributions in this limit as well.

10) Cash level / working capital

The above discussion has simplified things to enable comparisons. However, profit and retained earnings are not the same as cash and a company could make lots of profit but be cash poor.

Therefore, it should be noted that the company should keep sufficient cash in the business to fulfil its working capital requirements and a contingency should also be kept for a “rainy day”. It wouldn't be prudent to extract all the cash out of the business, and this could potentially limit the company's growth or lead to its collapse.