

Reaping the rewards you deserve

Having worked hard to build your business, how do you then extract maximum profit from it? Tim Dunn and Richard Godmon explain how to make sure that your money remains in your hands, not the taxman's.

For many limited company owners, efficient profit extraction is all about minimising tax suffered and maximising funds that can be withdrawn. Such an outcome is often associated with a dividend based remuneration strategy.

This is a course of action freely available to a profitable owner managed company. This approach sees the owners of the company supplementing relatively low salaries by declaring a high level of dividends each year.

There is no doubt that if applied correctly this policy can work, the ultimate outcome being a tax saving for the company whilst also enhancing the net income of the owner. As a very simple rule of thumb, we often see savings of around 10%-15% when companies follow this strategy.

However, despite this concept being widely recognised, only a relatively low percentage of companies stick closely to this principle. In this article we touch upon reasons why this is the case.

Choosing the right strategy

For some businesses there simply are insufficient profits available to allow payment of dividends. The owner manager is then forced down a route whereby the only form of remuneration available is salary or other employment related benefits.

There are a number of other business owners who simply do not understand the options available to them, and continue to extract profits simply by way of salary.

There are however many other companies, who are profitable and who are aware of potential savings of a dividend based approach, yet they still

choose not to blindly follow the principle. The reason for this is either good management or professional advice, which encourages the business owners to look beyond how to minimise their tax bill and to take a far more holistic view and consider additional personal and business related factors.

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As a firm we strongly believe that business owners need to carefully consider a number of issues before deciding upon a strategy for the extraction of profit.

A common starting point for any review is to understand the personal circumstances and income requirements of the current owners, together with future plans and expectations.

Identifying how much income the current owners need from the business, is critical to this process. There is no benefit in taking thousands of pounds of profit from the business if the income is not required.

Sensible tax planning should prevail and in doing so

ensures that all lower rate tax bands and allowances are fully utilised. However, drawing money in excess of these levels simply exposes more of an individual's income to higher rate tax bands.

Currently it is likely that the most tax efficient approach for a limited company is to retain profits in the business. Tax legislation and rates have favoured this approach for at least the last ten years.

Following this course allows reserves to accumulate within the company and then eventually these reserves can be realised when the business is sold or wound up. This should mean that money taken from the business is taxed as capital rather than income. The shareholder is therefore able to benefit from the generous capital gains tax reliefs which are available. Assuming entrepreneurs relief applies, the effective rate of tax enjoyed (if anyone enjoys tax), can be as low as 10%. This is certainly lower than higher rate tax currently suffered on dividend income.

This approach is often more attractive as the age profile of the owner manager increases. The older the shareholders, the shorter the likely time frame for realising these reinvested profits.

Retirement considerations

The age profile of the shareholders is an important consideration for effective profit extraction. It will also impact on the use of pension contributions as a means of extracting profits. For owners nearing retirement age pension contributions become more attractive. The individuals know that they will be able to utilise these contributions in a short time

frame and therefore may be more willing or likely to invest into pension funds.

Pension contributions can be a very tax efficient method of extracting profits, especially as current pension legislation allows for a tax free lump sum to be drawn once retirement age is reached.

At the other end of the spectrum, younger business owners should not ignore pension contributions, as they still remain a tax efficient way to shelter some of the profits within the limited company, whilst making longer term provisions for the owner's income. The problem for the younger owner is the deferment of the benefit from these profits for quite a considerable time. However, the use of pension funds to acquire commercial property used in the business may be attractive.

Ownership strategies

The longer term ownership plans of the business will also need to be considered when looking at a strategy for the extraction of profits. If the ownership is likely to change in the near future, maybe as a result of a likely sale, this has an impact on the optimum way to remove profits. In such circumstances profits will often be left within the company and taken as capital at the point of sale. As referred to above this is a very tax efficient outcome. Of course it is still important to ensure lower rate tax bands and allowances are all fully utilised.

However, if a plan exists to gradually pass the business to a new owner, then the changing share structure will impact on any dividend strategy. The creation of differing classes of share is a mechanism sometimes utilised to accommodate this.

The owner's family circumstance also has a part to play in any planning

discussions. Involving family members within the operation of the business can present tax planning opportunities, the benefits of which will often exceed the salary vs dividend debate.

Recognising the work undertaken by a spouse and paying a salary to ensure personal allowances are fully utilised, will be a more efficient way to remove profits than any dividend paid to the owner/manager. Like the dividend, the spouse's salary (pitched at an appropriate level) will not attract any PAYE or NI. However, unlike a dividend payment, the salary will save the company corporation tax at 21%.

Other benefits that the family enjoy should also be reviewed to consider whether the costs of these should be met by the company as part of the directors overall package. It is worth noting that salaries, dividends and other benefits paid to family members are perceived a relatively high risk area and it is important that the individuals concerned are active within the company and do receive reasonable remuneration in light of work done.

Practical issues

It is important to ensure the business owner's attitude to risk is understood and considered. This is another reason why not all companies push the level of dividends as part of their profit extraction strategy. Many businesses chose to pay a little more each year in tax and national insurance rather than adopt a policy that could lead to HMRC scrutiny.

Aside from tax implications and looking from a financial planning perspective, a dividend based remuneration approach may throw up practical problems. A dividend based approach can have implications

when it comes to either applying for mortgage or for critical illness policies. Some mortgage providers will not include dividend income within the applicant's relevant earnings. This may limit access to future borrowings. A similar approach is often undertaken by critical illness policy providers, who will only payout based on salary levels and not total income including dividends. It is important that the need for future borrowings/protection and any further associated financial planning is not overlooked when deciding upon policy.

Finally, the company's cash flow and working capital requirements must be considered when determining the timing and amount of funds to be taken out.

In conclusion when looking at profit extraction strategies, there are a number of factors that have to be considered. It is certainly not a one size fits all approach and although the low salary/high dividend based solution can yield positive results it is important to fully understand the bigger picture.

If you would like further information on how you could extract profits efficiently from your business, please contact your Menzies relationship partner or the authors of this article who specialise in providing advice to owner managed businesses:

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