Making tax efficient use of excess company profits

When you have excess profits in the company there are a few options available:

1. Pay the money out as a dividend and incur personal taxation. Invest or spend the money.
2. Keep the money in the company, avoiding further personal taxation and earn interest on the money in the company bank account.
3. Use the company money to invest in a pension avoiding all personal taxation.
4. Leave the money in the company ready for a capital gain when the company is dissolved.

This article discusses the issues.

IR35 Factors

This question is only relevant when you are working outside the scope of IR35, since only then do you have the choice not to pay out company income as salary.

Option1: Pay all profits out as a dividend

Under this option you could be liable to higher rate tax if your dividends take your income into the higher rate tax band.

Given that you are working outside the scope of IR35, you may wish to restrict your dividend drawings in order to postpone or possibly eliminate a liability to higher rate tax.

If you have no earnings outside of your limited company, then it is possible to take salary and gross dividend earnings up to a total of £36,145 before any higher rate tax liability arises.

It would not be worth restricting your drawings below that level (assuming you have the profits available in the company), since there would be no reduction in your income tax liability.

This is because the tax credit on the dividend effectively "franks" the dividend for the basic rate tax liability, so that no further income tax is payable on the dividend income up to that figure.

It is important to remember that the tax credits on your dividend are a part of the income to be included in the £36,145.

You therefore need to add together the sum of your gross salary, net dividends, tax credits and all other income received outside of your limited company.

All income up to £36,145 is taxed at the basic rate. Any excess dividends will be taxed at the higher rate of tax and you should set aside one quarter of the net dividends drawn after that amount.

See also: Dividends: Calculation, Taxation and Payments

Option 2: Leave the money in the company

This will avoid you having to pay higher rate tax on dividends but the bank interest received is unlikely to be substantial.

This option is useful if you believe you will not be earning as much money in the next financial year (perhaps due to a long holiday) and you wish to avoid paying higher rate tax in the current year and the following year.

Option 3: Investing in a pension

Investing in a pension can be done from company funds and is entirely tax free.

For those not caught outside IR35 it is tax efficient to invest up to £300 per month under the current pension rules. This will attract up to 33% tax relief because it saves the money you would have paid in higher rate tax and channels it to a pension rather than to the tax man.

See also:
Investing in a pension when not caught by IR35
Pension Options for Contractors

Option 4: Capital Gain on Dissolution

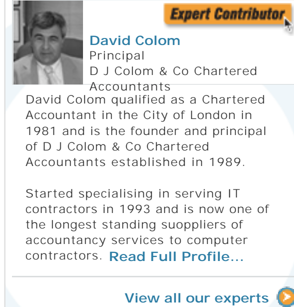
You can leave undistributed profits in the company to create a final capital gain when the company is eventually dissolved.

A maximum of £8,200 per shareholder can be distributed tax free at that point but in order to create such a gain, it is first necessary to have the profits available in the company at the point of dissolution.

See also: Closing Down Your Limited Company

Updated: Thursday, January 06, 2011

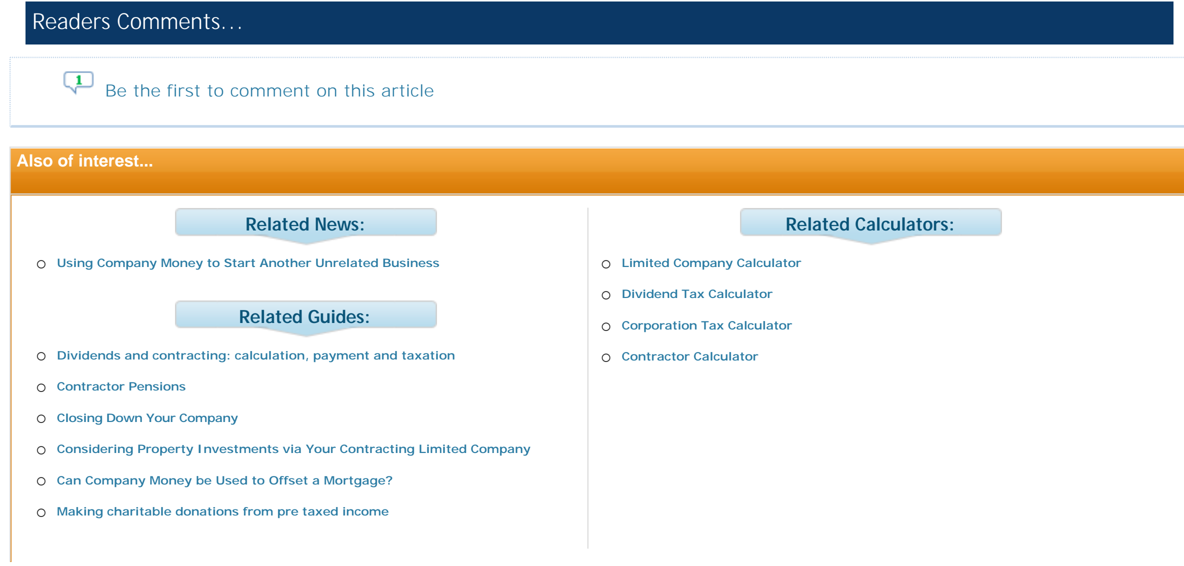
Tweet



© 2011 All rights reserved. Reproduction in whole or in part without permission is prohibited. Please see our copyright notice. If you want to use any content you have seen on this site then please request our media pack and ask for details of our Content Licencing Service.

Readers Comments...

Be the first to comment on this article



ABCe verified website - last audit confirmed **130,682 monthly unique visitors**

© Copyright 2011 Byte-Vision Limited UK. All rights reserved Copyright notice