Extracting profits tax efficiently from a limited company

Contractors seeking to extract profits tax efficiently from their limited company can choose from a range of strategies. For contractors who have individual earnings above the higher rate tax threshold, these can result in considerable tax savings.

“One of the major benefits that limited company contractors enjoy is the ability to choose how, when and how much they pay themselves,” explains James Abbott, founder and head of tax at contractor accountant Abbott Moore.

“This flexibility enables contractors to implement tax strategies to take profits from their limited company tax efficiently at the same time as enjoying other benefits, such as planning for their retirement or building up other investments.”

Abbott considers the tax planning measures a typical contractor earning an average of £400 a day, or £96,000 in gross fees a year might implement to keep them outside of the higher rate tax band. Those he discusses below include:

Company pension

Low salary/high dividends

Income splitting

Taking time off

Company investments

Director’s loans

Pensions – investing the government’s money

According to Abbott, the most basic of tax strategies is to **invest in a company pension**: “Contractors can invest up to £40,000 a year into a company pension scheme. The pension payments are deducted directly from the contractor’s gross fees and gain corporation tax relief with no benefit in kind (BIK) liability.

“This means the contractor could stay below the higher rate tax band by investing into the company pension scheme the balance of the surplus income in the company they would otherwise have taken as a dividend. And because of the tax relief, it is like being able to invest some of the government’s money for a period of time!”

> “The real benefit of the low salary high dividends strategy via a company is that for a given level of income being routed through the company, the contractor's personal tax bands are used up more slowly”
>
> James Abbott, Abbott Moore

Low salary, high dividends

Most limited company contractors working outside IR35 pay themselves a **low salary** and the balance of their remuneration as **dividends**, paid from company profits. Abbott recommends a gross monthly salary of £660, which works out at £7,920 a year, with the balance paid as dividends.

This is tax efficient because the contractor’s salary is under the £10,000 tax-free personal allowance. Paying the balance via a dividend means that no National Insurance Contributions (NICs) are payable, and there is no income tax payable on any earnings up to the higher rate tax threshold.

The government’s **Employment Allowance** introduced in April 2014 means it is possible for some contractors to pay a higher salary and be slightly better off, but contractors with income from other sources, such as property or investments, do not benefit from this scheme.

The benefits of dividends and grossing up

“The real benefit of the low salary high dividends strategy via a company is that for a given level of income being routed through the company, the contractor’s personal tax bands are used up more slowly,” continues Abbott.

“Taking a simple example, if a contractor’s company earns £10,000 they will be liable for £2,000 in corporation tax. That leaves an £8,000 dividend. But when the dividend is drawn out, it is ‘grossed-up’ to allow for the dividend tax credit, so you divide the £8,000 by 0.9 giving £8,889. The contractor has received £10,000 worth of income but only used £8,889 of their tax band.”

Abbott demonstrates the point by the following example:

	Company	Contractor

Company profits	46,108	
Salary	-7,920	7,920
Profits before tax	38,188	
Corporation tax	-7,638	
Profits after corporation tax	30,550	
Dividends	-30,550	30,550
Profits retained in the company	0	
Tax credit on dividend		3,394
Total personal income for tax purposes		£ 41,865

As higher rate tax doesn't start until £41,865, there will be no personal tax for the contractor to pay. The key point is that company profits of £46,108 have been distributed without incurring higher rate personal tax, £4,243 more than contractor might be expecting. This is due to the grossing up effect.

What happens when you bring a spouse in?

Contractors with a spouse or civil partner have the option of **income splitting**. This means the spouse owns a certain percentage of the shares, commonly 50%, and takes full advantage of the spouse's tax allowances. The spouse would also typically receive a salary, assuming they performed some genuine function within the business to warrant it.

Abbott warns that contractors adopting this strategy must beware of the **settlements legislation**, and so ideally must decide whether to split ownership of their company when incorporating.

If they do not split share ownership, dividends can only be paid to the single shareholder. Dividends must be paid out in the shareholding ratios too and risk of HMRC can be reduced significantly by avoiding the use of dividend waivers or different classes of share.

The 'grossing up' impact of the company has a similar impact on the income splitting scenario.

"Adding two lots of £46,108 means that the company can pass out net profits (after corporation tax has been paid) to a contractor and their spouse of £92,216 before paying any further income tax. Assuming the contractor has a reasonable amount of expenses in their business, a typical contractor earning £96,000 a year who is able to income split with a spouse won't pay any NICs or income tax, plus their spouse will benefit from NI contributions."

Taking a sabbatical

Abbott notes that taking a sabbatical merely to save tax is not an effective tax strategy, but when combined with a contractor's lifestyle choices can lead to some tax efficiencies: "Contractors are always going to be better off working than taking time off, except under very exceptional circumstances."

If a contractor decided to take some time out, they can continue to take dividends from the company even if it is not receiving any income, assuming there are profits and cash in the company to cover the amounts. Because the contractor can decide how and when the company money is drawn out, they could draw it out when they are a basic rate taxpayer.

"This strategy only works if the contractor is able to defer the income into another tax year," says Abbott. "If they are a higher rate taxpayer in May and decided to take time off in the autumn, they would not benefit because the delay is not long enough. To work, this strategy must straddle two tax years."

Putting surplus cash into company investments

Contractors can choose to **invest their company's surplus cash into assets**, which could include anything from property to fine art and antiques, financial instruments and even precious and **rare earth metals, like gold**.

Once, Abbott would have warned contractors to watch the company's trading status, because if investment income exceeds a certain threshold then the company becomes a Close Investment Company (CIC) and the higher rate of corporation tax must be applied to profits.

"This distinction is becoming less relevant now that the main rate of corporation tax is close to the small companies rate," explains Abbott. "But contractors should watch their expenses and not assume everything will be tax deductible if they are no longer trading as a consultant."

Entrepreneur's relief (ER)

Using **Entrepreneur's relief (ER)** to shut down a company can result in a contractor extracting their cash savings and only paying 10% capital gains tax. However, HMRC has rules that prevent contractors from deliberately saving large sums of cash for this reason.

There are also rules preventing serial 'ER' use, where a contractor repeatedly opens and shuts companies specifically to benefit from the 10% tax rate.

"If the profits are too large to deal with under the basic rate band dividends, then under certain circumstances ER might be an appropriate option," Abbott suggests. "But you can't beat a 0% personal tax allowance and in almost all cases if a contractor has any basic rate band left and the company any money to distribute, they should use it."

Director's loans

Using a director's loan could provide a contractor with access to some of their cash in one financial year which they can then clear with a dividend in the next financial year. There is a potential cost in the form of beneficial loan interest, but this does not take effect until a loan exceeds £10,000.

"There are plenty of scenarios where contractors can benefit from the tax efficiency of this strategy," highlights Abbott. "Let's say a contractor has used up their basic rate, but it is February and they need another £8,000 quickly for a deposit on a new car.

"The contractor can take another £8,000 in dividends, push themselves into the higher rate tax band and pay £2,000 of income tax. Or they could take an £8,000 director's loan in February and then, after 6 April, declare a dividend that repays the loan. There is no beneficial loan interest because the loan is under £10,000, and as long as it is repaid within 9 months and 1 day of the company's year end, then section 455 would not apply."

Abbott urges contractors adopting this strategy to make it clear that the payment is a loan, and to maintain detailed records. Otherwise, HMRC could classify the transfer as a dividend or salary.

Developing a tax strategy

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James Abbott is the owner of Abbott Moore LLP and often speaks on freelancer / contractor tax matters. He has his own growing portfolio of contractor clients.

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Abbott recommends that contractors develop their tax strategies in the following structured way:

The contractor needs to work outside IR35 – if they are not doing so, they should move to a contract that is outside IR35

Decide on a suitable salary level

Maximise expenses, and make sure they are correct

Pay dividends. This tends to be the variable element and timing is crucial – is the tax rate paid by drawing out the cash now going to be less than the tax rate that will be paid by drawing out the cash later?

Seek professional advice if the financial impact of a decision is likely to be significant.

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