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proactive business advice

Extracting profits from your business

A guide to tax-efficient profit extraction for business owners.

Owning and running your business is a tough proposition but it is vitally important that people continue to do it. As well as the rewards that come from hard work and determination, there are also monetary benefits to running your own business.

There are a variety of ways in which profits can be taken out of a business, each with their own tax implications. And, of course, tax rules have a habit of changing over time so strategies that worked in the past may not be best suited to the present.

The basics

When we talk about profit, in its simplest sense we are talking about:

total revenue – total expenses = profit

This means that profit is whatever is left over once a company has paid its taxes, rent, bills, salaries and other expenses.

Although every business' goal is to make profit, it can take a long time.

Corporation tax is levied on the profits a company makes from doing business ('trading profits'), investing and selling certain assets for more than they were originally bought for ('chargeable gains').

The current rate of corporation tax is 20% but it is due to reduce:

- 19% in 2017/18
- 17% in 2020/21.

Individuals have to pay income tax on the money they make from employment or the profits they make from being self-employed. Most people are entitled to a tax-free allowance of £11,000, after which they pay the following rates:

Band	Taxable income	Rate
Basic rate	£11,000 to £43,000	20%
Higher rate	£43,001 to £150,000	40%
Additional rate	Over £150,000	45%

Talk to us about your tax liability.

Strategies for profit extraction

In the whirl of trying to keep your business alive and growing, it can be hard to get round to thinking about what is the best way to take the profits out of your company. The right strategy will depend on your life goals, your current situation and the type of business that you own.

Salaries and bonuses

The most obvious way to move the profit from the company to you is by paying yourself a salary. Since you do not pay any tax on the first £11,000, you will pay 20% income tax on any salary you take that is between £11,000 and £43,000. If you go over that threshold your income tax liability shifts to 40%.

Employee class 1 national insurance contributions (NICs) of 12% are due on salaries above £155 a week.

Tax on salaries is deducted through PAYE.

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There will also be employer class 1 NICs of 13.8% due on salaries above £156 a week. The rules regarding NICs are different for directors as they pay NICs on income over £8,060 a year on annual income rather than earnings in a particular pay period.

With bonuses the tax liability will depend on whether the payment in question is cash or non-cash. If the bonus is cash, or vouchers that can be exchanged for cash, it should be treated as earnings and be subject to PAYE and NICs. If the bonus is not cash the rules are dependent upon the kind of item it is.

Contact us to talk about tax and bonuses.

Dividends

Dividends have undergone big changes in recent times. A common strategy has been to draw a salary of around £8,000 while also receiving dividends. Previously there was a 10% dividend credit that applied to extracting profits in this way.

As of 6 April 2016 the tax credit has been replaced with a £5,000 annual dividend tax allowance. Dividend income that exceeds £5,000 and the income tax personal allowance is taxed at the following rates:

- basic rate: 7.5%
- higher rate: 32.5%
- additional rate: 38.1%.

An important distinction between salaries and dividends is that the latter can only be paid out of profits while an individual can continue to draw a salary during a loss making period.

Other points for consideration about dividends:

- dividends paid within pension funds and those received in shares from ISAs are tax-free
- dividend income is not included when calculating the personal savings allowance of £1,000 (£500 for higher rate taxpayers)
- all tax is deducted and paid through self-assessment.

We can help you understand dividends.

Pensions

Contributing into a pension can be a tax-efficient way of extracting profits from a commercial entity. The contributions that you pay will benefit from government tax relief and they are not taxed while they are invested in your pot.

Pension contributions can be paid both by an individual or by a company. They are not treated as a benefit and are therefore not liable for income tax or NICs.

There is a £40,000 limit on the amount of money that can be put into a pension each year. The annual allowance is reduced by £1 for every £2 of income for those with an income above £150,000 including pension contributions, up to a maximum reduction of £30,000.

When you access your pension pot, you can withdraw the first 25% as a tax-free lump sum. If you withdraw the rest it will be taxed at your marginal rate.

Contributing to a pension can be thought of as a tax-efficient long-term investment as unless you plan to work well into old age, you are going to need a retirement income.

Benefits in kind

Benefits in kind are the benefits that employees or directors receive through their employment but which are not included in their salary or wages.

Common types of benefits in kind are company cars, medical insurance and certain kinds of childcare arrangements.

A number of benefits are tax-free, including the following:

- subsidised or free meals
- sports facilities
- work travel
- bicycles and equipment.

We can assist you with benefits in kind.

Retaining the profits

As well as extracting profits, it may also be a good strategy to keep some money within the company. The company can either hold on to the money or use it to invest in shares or property in much the same way an individual would.

If the profits from 1 time period are retained within the company they can be used for a number of potential purposes such as:

- funding bonuses in poor performing years
- as a separate retirement fund
- to extract as a capital gain if you should decide to wind up the company (this could be very tax-efficient if the gains qualify for entrepreneurs' relief).

Ultimately, it is likely that you will choose to utilise a number of the strategies outlined in this article to reap the financial rewards of your hard work and dedication. The important part of the process then becomes finding the right mix.

We can advise you on a strategy that works for you.