You really got me …

PETER RAYNEY looks at future cash extraction for owner-managed companies under the 50% super tax regime.


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After the 2009 budget, many successful owner-managers were left feeling decidedly uncomfortable. Despite Mr Darling's economic justifications, the introduction of a super tax rate of 50% from 6 April 2010 marked an ominous return to the 'Old Labour' ethos of taxing the rich 'until the pips squeaked'! And with the unprecedented level of government debt, many predict that it's unlikely to end there.

Because of the relatively haphazard way in which changes have been made to our company/personal tax regime, we now have a system where the overall rates of tax and National Insurance contributions (NICs) for extracting different types of income from an owner-managed company will vary according to a number of different factors. With spiralling income tax rates (together with the hefty NIC rates), owner-managers will be looking to reappraise the most tax efficient ways of extracting income from their companies.

Profits available for extraction

Typically, the owner-manager will pay himself a basic salary and provide appropriate tax efficient benefits. After this, most discussions about profit extraction usually start by focusing on the amount available to be paid out to the owner-manager(s) as their 'proprietorial reward'. This can be influenced by one or more of the following considerations.

- The owner-manager's personal spending and saving requirements, and their personal tax position.
- The amount required for future retention in the business (to satisfy future working capital or capital investment purposes).
- The level of the company's distributable reserves and 'free' cash flow.

KEY POINTS

- How should profit be extracted from a limited company?
- The tax principles of bonus or dividend payments.
- Comparative rates for 2009/10 and 2010/11.
- Dividend planning before 6 April 2010.
- The relevance of income splitting and beneficial loans.

- Any provisions or restrictions laid down in shareholder agreements or the company's articles, particularly where venture capital finance has been used.
- The desire to 'de-risk' part of any surplus cash generated by the business by taking it out of the company.
- 'One-man-band' type service companies may be affected by IR35 considerations in fixing the level of 'remuneration' to be paid out and so on.

Having broadly determined the appropriate level of profits that can be extracted by the owner-manger, attention then usually shifts to deciding whether the amount should be paid out as a bonus and/or dividend.

Bonus v dividend

For many years, higher rate taxpayers have been subject to a special tax rate of 32.5% on their dividend income. Because dividends carry a tax credit of 10%, this means that they are taxed at an effective rate of 25% on the dividend payment, as shown in ***Calculation 1***.

If a company pays tax at the small companies' rate, it is particularly beneficial to extract 'surplus' profits by means of a dividend. This general presumption may not hold true where other considerations, such as obtaining tax relief for personal pension contributions, are in play.

Some owner-managers may be tempted to extract their income entirely in the form of dividends, but it is often sensible to extract a reasonable level of salary. In any event, if the owner-manager has no other taxable income, it is better to pay at least a sufficient salary to use up the personal allowance (since no 10% tax credit is available to the extent to which dividends are covered by personal allowances).

Bonuses are currently taxed at different income tax rates (20% or 40%). In 2009/10, bonuses attract employers' NIC at 12.8%

EXAMPLE 1

Ray is a 100% shareholder of Dedicated Follower Of Fashion Ltd. The company expects to have surplus profits of £100,000 for the year ended 31 March 2010, which are available to be paid out to Ray. Ray already draws a monthly salary of £4,000. It is not yet known whether the company will pay tax at the small companies (21%) or main rate (28%).

The overall marginal tax costs of paying out £100,000 as a bonus or dividend are shown below:

2009/10	*Tax/NIC rate*	*Bonus*	*Dividend*	
			CT @ 21%	*CT @ 28%*
Available profit		£100,000	£100,000	£100,000
If bonus is paid: less employer's NIC on net bonus at:	12.80%	11,347		
If dividend is paid: less corporation tax on profit at:	21.00%		21,000	
Or at:	28.00%			28,000
Available for bonus/dividend to Ray		88,653	79,000	72,000
If bonus: less personal income tax/NIC at:	41.00%	36,348		
If dividend: less effective tax at:	25.00%		19,750	18,000
Post-tax receipt		£52,305	£59,250	£54,000
Effective tax rate		*47.70%*	*40.75%*	*46.00%*

CALCULATION 1

Cash dividend	£90
Tax credit (1/9)	10
Gross dividend	100
Dividend tax @ 32.5%	32.50
Less: Tax credit	10.00
Tax payable	£22.50
Effective rate (22.5/90 x 100%)	*25.00%*

CALCULATION 2

Cash dividend	£90
Tax credit (1/9)	10
Gross dividend	100
Dividend tax @ 42.5%	42.50
Less: Tax credit	10.00
Tax payable	£32.50
Effective rate (32.5/90 x 100%)	*36.11%*

(on earnings above £5,715). No employees' NIC is payable on earnings up to £5,715; but earnings between £5,715 and £43,875 then attract employees' NIC of 11%. Where the recipient's normal annual salary and P11D benefits exceed £43,875, further employee's NIC of 1% will be due on the amount above that limit.

The bonus and employer's NIC is fully deductible for corporation tax purposes for the period in which it is charged in the accounts (provided it is actually *paid* within nine months following the end of the accounting period, CTA 2009, s 1288). It is also necessary to ensure that any bonus provision made in the company's accounts is FRS12 compliant; i.e. it must have arisen as a result of a legal or constructive obligation to pay the bonus which existed at the balance sheet date.

When compared with dividends, it is worth noting that tax and NIC on a bonus is suffered 'up-front' under the PAYE system. The company must account for the PAYE and total NIC within 14 days after the tax month of payment.

A 'bonus v dividend' comparison for a typical owner-manager in 2009/10 is set out in ***Example 1*** above.

In ***Example 1***, the overall tax/NIC rate for the bonus would not be affected by the company's corporation tax rate – since the bonus is tax-deductible. On the other hand, the pre-tax surplus profits must suffer corporation tax before they can be distributed as a dividend and hence the corporation tax is part of the tax suffered on those profits.

If the company's marginal corporation tax rate for the year ending 31 March 2010 was 29.75% (i.e. where the profits fall between the relevant limits of £300,000 and £1,500,000), the effective rate for a dividend would be 47.31%.

As a general rule, ***Example 1*** shows that dividends will often be preferred to bonuses (particularly when the timing of the tax payments are taken into account).

Looking beyond 5 April 2010

As mentioned, the 2009 budget imposes a new super tax rate of 50%. This will apply from 6 April 2010 where an individual's taxable income exceeds £150,000. For those owner-managers who earn substantial salaries/bonuses, this tax hike will mean that the combined marginal tax/NIC costs for employment income (above £150,000) would be 51% for the individual and 12.8% for the employing company – all quite painful.

From 6 April 2010, dividends also become subject to their own super tax rate of 42.5% (which are taxed as the top slice of income).

EXAMPLE 2

Ray, from *Example 1*, anticipates having the same surplus profits of £100,000 for the year ended 31 March 2011. If Ray's total taxable income (including the bonus/dividend) falls *below* the £150,000 super tax income threshold, the relevant bonus v dividend calculations for 2010/11 would be as follows:

2010/11

	Tax/NIC rate	*Bonus*	*Dividend*	
			CT @ 22%	*CT @ 28%*
Available profit		£100,000	£100,000	£100,000
If bonus is paid: less employer's NIC on net bonus at:	12.80%	11,347		
If dividend is paid: less corporation tax on profit at:	22.00%		22,000	
Or at:	28.00%			28,000
Available for bonus/dividend to Ray		88,653	78,000	72, 000
Less: Income tax/NIC at:	41.00%	36,348		
Less: Effective dividend tax at:	25.00%		19,500	18,000
Post-tax receipt		£52,305	£58,500	£54,000
Effective tax rate		*47.70%*	*41.50%*	*46.00%*

EXAMPLE 3

Ray, from *Example 1*, anticipates having surplus profits of £100,000 for the year ended 31 March 2011. However, he will already have had total taxable income *above* the £150,000 super tax income threshold, so the relevant bonus v dividend calculations for 2010/11 would be as follows:

2010/11

	Tax/NIC rate	*Bonus*	*Dividend*	
			CT @ 21%	*CT @ 28%*
Available profit		£100,000	£100,000	£100,000
If bonus is paid: less employer's NIC on net bonus at:	12.80%	11,347		
If dividend is paid: less corporation tax on profit at:	22.00%		22,000	
Or at:	28.00%			28,000
Available for bonus/dividend to Ray		88,653	78,000	72,000
Less: Income tax/NIC at:	51.00%	45,213		
Less: Effective dividend tax at:	36.11%		28,165	26,000
Post-tax receipt		£43,440	£49,835	£46,000
Effective tax rate		*56.56%*	*50.17%*	*54.00%*

This corresponds to an effective rate of 36.11% of the cash dividend received, which will apply to dividend income falling within the '£150,000 plus' taxable income, as shown in ***Calculation 2***.

Where substantial dividends are being paid (falling within the £150,000 plus income band), this represents an increase of nearly 45% on the pre-6 April 2010 effective dividend tax rate of 25%. Dividend income *below* the £150,000 super tax threshold will remain subject to the effective rate of 25%. Going forward, owner-managers should therefore exercise more care with the timing of their dividend payments to lessen the impact of the new top effective rate of 36.11%. This is illustrated by ***Example 2***, which compares the rates applying to bonuses and dividends in 2010/11.

However, if the bonus or dividend *entirely fell above* the £150,000 threshold, the relevant tax and NIC costs would alter as demonstrated by ***Example 3*** above.

Even this level, i.e. above the £150,000 threshold, dividends will still be less costly (due to the 10% tax credit and the lack of NICs).

Pre-6 April 2010 dividend planning

Many owner-managers are likely to accelerate the payment of planned future dividend payments before the super dividend tax rate 'kicks-in' on 6 April 2010. Some may feel that their company's cash-flow may not be able to support large dividend payments, but this should not be the case. The owner-manager can pay the dividend (before April 2010) – remembering that the 'tax point' for interim dividends is the date they are paid (see *Potel v IRC* [1970] 46 TC 658). All or most of the dividend monies can then be lent back to the company by crediting the

EXAMPLE 4

Victoria is a 40% ordinary shareholder in her husband's company, The Village Green Preservation Society Ltd.

She could receive a dividend of up to (say) £39,400 in 2009/10 without incurring any further tax liability, as computed below. (This is because the taxable dividend falls within the basic rate band and is therefore taxed at the 10% dividend rate. The tax credit can only discharge tax at the 10% rate and cannot be used to offset any higher dividend tax rate liability.)

	£
Cash dividend	39,400
Tax credit (1/9)	4,378
Gross dividend	43,778
Less: Personal Allowance	6,475
Taxable income	37,303
Income tax at 10%	3,730
Less: Tax credit	4,378
Tax payable	Nil

shareholder's loan account. The 25% effective income tax liability on the dividend would need to be found by 31 January 2011.

HMRC's *Company Tax Manual* (at CT20095) treats *interim* dividends as being paid when an 'unreserved right' to draw a dividend exists, such as when they are credited to the owner-manager's account in the company's books. HMRC go on to say that if 'as may happen with a small company, such entries are not made until the annual audit, and this takes place *after* the end of the accounting period in which the directors resolved that an interim dividend be paid, then the 'due and payable' date is in the later rather than the earlier accounting period'.

This can be a murky area and therefore it will be important to ensure that everything is done to ensure that the required dividend is legally valid and paid before 6 April 2010. I generally prefer an exchange of cheques (for the dividend and the loan-back) to 'stamp' the timing of the dividend payment beyond doubt.

Income splitting still rocks

Following HMRC's defeat in *Jones v Garnett* 2007 STC 1536 (often referred to as the *Arctic Systems* case), a large number of owner-managed companies continue to take advantage of providing tax efficient dividend payments to the owner-manager's spouse. The key point here is that, while such arrangements are likely to be a settlement for income tax purposes (following the House of Lords' analysis in *Arctic Systems*), the transfer/issue of ordinary shares to the spouse to effect the desired dividend payments is protected by the 'outright gifts' settlements exemption for married couples/civil partners in (what is now) ITTOIA 2005, s 626.

This means that the dividends paid to the spouse will be treated as tax advantageous income in their hands (and not taxed on the 'settlor' owner-manager under the 'settlements' legislation in ITTOIA 2005, s 624 and s 625).

Immediately following their defeat in *Arctic Systems*, HMRC told us that such arrangements were 'unacceptable and unfair' and they were therefore going to introduce legislation to counter so-called income shifting or income shifting practices. However, HMRC's attempts to introduce anti-avoidance legislation were quickly derailed in the face of a massive 'thumbs-down' by the professional bodies and industry groups. The draft legislation was shown to be completely unworkable and it was difficult to see how it would be policed by HMRC and how they would collect the anticipated tax revenues! The advantages of paying a tax efficient dividend to a spouse in 2009/10 (who has no other taxable income) are illustrated in ***Example 4***.

Mr Darling seems to have shifted 'income splitting' onto the back-burner – at least for the time being – following statements issued in both the pre-budget report 2008 and the budget 2009. Income splitting (provided it is implemented correctly) is therefore very much alive and kicking!

Hitherto, the splitting of dividends between married couples has largely been designed to make full use of the spouse's 10% basic rate band for dividends. After 6 April 2010, it may be given a further twist as owner-managers seek to mitigate the effect of the 36.1% effective rate for dividends.

Loans to shareholders

Under the post-6 April 2010 regime, some might consider making use of loans rather than dividends. Based on current understanding, there are no plans to increase the rate of the TA 1988, s 419 tax – which is 25% of the amount of the loan/overdrawn current account. Even when the income tax (and NIC) under the beneficial loan rules (ITEPA 2003, s 175) is added on, loans to owner-managers may still prove to be a more attractive option than an outright dividend payment suffering the relevant super tax rate of 36.1%.

It is important to ensure that the loan is properly documented. Although it may seem tempting to draw regular loans/advances, these payments may look like 'PAYE-able' earnings to a vigilant tax inspector.

Planning for the owner-manager

As we move forward into the super tax regime, owner-managers should pay more attention to their cash extraction strategies. With income tax rates set to rise dramatically, companies can become very efficient tax shelters, since they can generate and retain profits at comparatively low tax rates. There is no need to extract more cash than is necessary to support the owner's lifestyle! In future, timing of bonus and dividend payments becomes more important to regulate the amount of income exposed to the super tax rates.

There is no need for the owner-manager's 'pips to squeak' … well not just yet!

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