This is just for UK advisers – it's not for use with clients.

Adviser Guide

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The information in this guide is based on our understanding, of current taxation, legislation and HM Revenue & Customs (HMRC) practice, all of which are liable to change without notice. The impact of taxation (and any tax reliefs) depends on individual circumstances.

Welcome from Prudential

Being a small to medium size business owner requires multi-tasking in the extreme, a fact known only too well by many professional advisers, who themselves may be in the same position and/or have many business owners as clients. Even with good people around them, to be successful the business owner needs to have a grasp of so many aspects of running a business. And this needs to be combined with an energy and appetite for success that many in the employed world might find daunting. However, there is a danger their business can become all absorbing, so much so that sometimes the business owner can forget the very person that they started the business for...themselves.

Financial advisers can help facilitate the process of business owners considering how they can best help themselves. They can do this by being the subject matter expert and helping them to identify, understand and act on the efficiencies that can be achieved within areas such as corporate investment and profit extraction.

Although most business owners understand the need to nurture their business and the people through which the business derives its success, ultimately it is the business owner who needs to be nurtured. It is they who took/takes the risks, sheds the blood, sweat and tears, and as such, it is they who should reap the rewards of their endeavours.

But how do they do that to best effect? Do they take the minimum income and leave value to accumulate within the business? This may appear to minimise the tax bill, but the value still sits within the business; and it leaves the issue of what to do with the money while it sits in the business. Or, do they take out the value on a regular basis, this puts the value in the hands of the individual, but the taxman will want a higher share of the proceeds; would salary or dividends work best? Or is there a third way? A way that the business owner can extract profits, in a tax-efficient manner, putting the asset firmly in the hands of the individual, providing security of asset, a way that legislation encourages and has many advantages over the other two methods.

The third method is of course pensions, which are even more attractive to the business owner following the introduction of ‘pensions freedom’ in April 2015.

In reality you should never put all your eggs in one basket. It will be a combination of all three of the above methods that will be required; some profits left in the business to provide cash flow/working capital (although this still leaves the issue of how best to invest this money); an appropriate level of spendable income to the owner in the form of salary and/or dividends; and pension contributions to provide tax efficiency, security of assets, personal wealth, post age 55 access to that wealth and, ultimately, a reduced risk exit strategy that is often missing from many business owners plans.

In this guide we explore many of the above subjects, information that many small to medium owners could benefit from. Our account management team are always available to support those to whom the business owner turns to for advice on such matters.

If only the business owner had someone who could help and mentor them to invest some of their valuable time in themselves. Such a person is surely worth their weight in gold.

Les Cameron
Head of Technical
Les Cameron is Head of Technical at Prudential, based in Craigforth, Stirling.

Les covers most areas of financial planning, specialising in the pensions technical arena. Les joined Prudential in 1997 and has held various pensions technical and management roles throughout his career. Les holds the Advanced Diploma of the Personal Finance Society and has a BA in Financial Studies.

Corporate investing

Why should companies invest surplus cash?

Conventional investment theory holds that companies holding surplus cash should distribute this by way of dividend because shareholders are better placed to make investment decisions than the directors.

There are also Return on Capital Employed (ROCE) issues – reinvesting cash in the company's business will usually generate the 'best' return for shareholders (double digit returns would be the norm).

However, there will be situations in which a company has surplus funds that it doesn't want to distribute and which can't be reinvested in the business.

In such situations the company could consider investing those surplus funds in a way that would generate a better return (net of tax and expenses) than that achievable on 'simple' bank deposits.

This section looks at two possible investment options – company-owned life assurance contracts and company-owned capital redemption contracts.

A life assurance contract must have the following elements:

(a) the contract must provide that the insured will become entitled to something on the death of the life assured;

(b) the insured must have an insurable interest in the life assured.

The contract will usually contain additional elements including the right to surrender the value of the contract at any time.

It is the ability to surrender which makes this type of contract an 'investment'.

A capital redemption contract is one which, in return for one or more fixed payments, a sum or series of sums of a specified amount (based on actuarial calculations) become(s) payable at a specified time.

It is widely accepted that investment decisions should not be based solely on tax factors.

Tax considerations

Corporation tax – the basics

A company resident in the UK is chargeable to corporation tax on all of its profits wherever those profits arise and whether or not they are received in, or transmitted to, the UK.

The charge to corporation tax is levied on the profits arising in a company's accounting period.

The corporation tax computation for any company for an accounting period includes:

- any income of the company arising in that accounting period, and
- any chargeable gains arising in that accounting period.

The income and the chargeable gains are aggregated to arrive at the total profits of the accounting period.

The rate of corporation tax is 19% from 1 April 2021.

How are company owned life assurance policies (and capital redemption policies) taxed?

Finance Act 2008 brought investment style life insurance contracts within the 'loan relationship' regime.

This requires that:

"... amounts to be brought into account by a company as credits and debits for any period... are those that are recognised in determining the company's profit or loss for the period in accordance with generally accepted accounting practice."

If a company uses **historic cost** accounting it will be taxable on the profit made on part surrenders, full surrenders, assignments for value and death of the last life assured.

If a company uses **fair value** accounting it will be taxable on the profit made on part surrenders, full surrenders, assignments for value and death of the last life assured and/or on the increase in value of the bond each year.

Over the life of the bond the company will pay tax on the actual profit it has made regardless of the accounting basis used.

In general, micro-entities will be able to use historic cost accounting; other companies must use fair value accounting.

To be a micro-entity a company must fulfil at least two of the following conditions:

- turnover must be not more than £632,000
- the balance sheet total must not be more than £316,000
- the average number of employees must not be more than 10.

Insurable interest

The company is investing in a life assurance contract and it is necessary that it can demonstrate insurable interest in the selected lives assured. The usual lives assured would be directors whose death would cause financial detriment to the company.

'Non-trading companies' are unlikely to be able to demonstrate insurable interest.

Capital redemption contracts could be used as an investment vehicle where no insurable interest exists.

The law relating to insurable interest is currently being reviewed by the Law Commission.

Inheritance Tax (IHT)

Will investment in a life assurance/capital redemption contract impact on the availability of IHT business relief?

Business relief, or business property relief (BPR) as is it often called, gives a substantial relief from tax.

The legislation, Inheritance Tax Act 1984 sections 103-114, is 'designed' to prevent taxpayers from getting the benefit of business relief for private assets. The legislation achieves this by confining business relief to assets needed for the business.

Business relief is not due where the business, or the business carried on by the company, consists wholly or mainly of:

1) dealing in securities, stocks and shares,
2) dealing in land or buildings, or
3) making or holding of investments.

Under IHTA s.112 (1) the value of any 'excepted assets' is to be left out of account for the purposes of business relief. In order not to be 'excepted' an asset must pass one of two tests:

- It must have been used wholly or mainly for the purposes of the business in question throughout the two years, or such lesser period as the transferor owned the asset (or a corresponding interest in the asset in the case of an interest in a business), immediately preceding the transfer of value.
- Alternatively it must be required at the time of the transfer of value for future use for the purposes of the business in question.

The 'future use' test was considered in Barclays Bank Trust Co Ltd v CIR SpC 158.

A lady died holding half the shares in a company. Her husband held the other half. The company's trade was the sale of bathroom and kitchen fittings, mainly to 'trade' customers.

The company's turnover at the time of the lady's death was approximately £600,000. It held £450,000 in 'cash' invested for periods of up to 30 days. HMRC accepted that the company needed £150,000 but determined that £300,000 was an 'excepted' asset.

The Special Commissioner posed the question as follows, at para. 10 of his decision:

"Was the £300,000 cash held by the company required on 23 November 1990 for future use for the purposes of the business? This is a question of fact and on the evidence before me I cannot find that it was so required. I do not accept that "future" means at any time in the future nor that "was required" includes the possibility that the money might be required should an opportunity arise to make use of the money in two, three or seven years' time for the purposes of the business. In my opinion and I so hold that "required" implies some imperative that the money will fall to be used upon a given project or for some palpable business purpose."

Whether this test is satisfied is a question of evidence in the circumstances of the particular case.

Three points should be made:

1) Only the value of excepted assets is left out – the remaining value (assets) get BPR (assuming the conditions are satisfied).
2) Cash is as much an 'excepted asset' as a bond – so switching from cash to a bond (or vice versa) should have no effect on availability of BPR.
3) The availability of BPR is only 'tested' on a transfer including a transfer on death. Spouse exemption might be available.

   A bond could thus remain a suitable investment 'home' in the medium to long term. The bond could be distributed, perhaps by way of dividend, before an IHT 'event' occurs.

The following on cash holdings and BPR were sent to HMRC by the Chartered Institute of Taxation (CIOT) and the Society of Trust and Estate Practitioners (STEP) in late 2013.

- Where a company holds an amount of cash which is in excess of the amount which it 'normally holds' and there is no evidence of any given project upon which the funds will be expended, then BRP relief will be denied as the excess will be treated as an excepted asset.
- Members are aware of the HMRC guidance in IHTM25352, IHTM25342 and SVM111220 and this guidance has proved sufficient in demonstrating the position of HMRC. It clarifies that cash balances should be viewed in light of the business's trading cycle and that businesses should keep evidence of discussions surrounding the intended use of cash balances.
- However, in the light of the current economic climate and in order to weather the financial adversity faced by many businesses within the UK, it is widely recognised that businesses are retaining increased cash buffers in case of any further downturn in their trade. This is a widely accepted tactic in surviving a recession to ensure that businesses succeed and reverts to the cliché that 'cash is king'.
- In this regard, confirmation from HMRC that they are aware of this change in mindset of business owners and company directors, and look favourably on surplus cash held in this regard, would be extremely useful to our members.

The HMRC response was:

- We understand that due to the financial circumstances in which businesses find themselves, they may choose to hold more cash in case of a potential downturn in trade. We can also confirm that in recent times we have seen this on a more frequent basis where businesses hold cash in excess of what they would traditionally require.
- However, our guidance remains the same, and unless there is evidence which directs us to the fact that the cash is held for an identifiable future purpose, then it is likely it will be treated as an excepted asset. Therefore the holding of funds as an 'excess buffer' to weather the economic climate is not a sufficient reason for it not to be classed as an excepted asset.

Capital Gains Tax (CGT)

Will investment in a life assurance/ capital redemption contract impact on the availability of capital gains tax Business Asset Disposal Relief?

Business Asset Disposal Relief is due, subject to meeting certain conditions, in respect of capital gains arising on 'material disposals of business assets'. These 'business assets' include:

a disposal of shares in a company which is either:

- a trading company,
- or a holding company of a trading group,

where the individual making the disposal satisfies certain conditions.

The relevant legislation defines a 'trading company' as a company which carries on trading activities and does not carry on other activities to a substantial extent.

Most companies and groups will have some activities that are not trading activities. The legislation provides that such companies and groups still count as trading, if their activities, "... do not include to a substantial extent activities other than trading activities".

The phrase 'substantial extent' is used in various parts of the Taxation of Chargeable Gains Act 1992 (TCGA1992) to provide some flexibility in interpreting a provision without opening the door to widespread abuse.

In the opinion of HMRC 'substantial' in this context means more than 20%.

How should a company's non-trading activities be measured to assess whether they are substantial?

There is no simple formula but some, or all, of the following are among the measures or indicators that might be taken into account in reviewing a particular company's status:

(a) Income from non-trading activities

(b) The company's asset base

(c) The company's history

(d) Expenses incurred, or time spent, by officers and employees of the company in undertaking its activities

(e) A balance of (a) – (d) above.

The indicators discussed should not be regarded as individual tests to which a 20% 'limit' applies. They should be applied 'in the round'.

The existence of 'goodwill' may need to be considered when applying the 20% test.

In the context of a company holding a bond, the 'asset base' test (alone) might be conclusive.

The holding of an investment can, in certain circumstances, be regarded as part of a company's trading activity.

The HMRC view on this is:

"Normally, making an investment that yields investment income would not count as a trading activity. However, there are a number of circumstances where such activities could be undertaken in the course of, or for the purposes of, a company's, or group's, trade. An investment may be so closely related to the conduct of a trade that it effectively forms an integral part of the trade. For example, a travel agent may be required to keep a fixed level of cash on deposit for bonding requirements. Or a company, or group, might receive a large payment, perhaps from selling a shareholding or on the completion of a major contract, and earmark the funds for some particular trade purposes, such as to meet some demonstrable trading liability or expand the trade in the near future.

The short-term lodgement of such surplus funds, for example in an interest-bearing deposit account or in bonds or equities, could count as a trading activity. Alternatively, the company, or group, may intend distributing the monies received to its members. Depending on the facts, temporarily investing such funds until they can be distributed could count as being an activity undertaken for the purposes of the company's, or group's, trade, since paying out the profits generated by a trade can count as a trading activity. This would be the case, for example, where the payment of an annual dividend depended on a meeting of the company's shareholders.

However, the long-term retention of significant earnings generated from trading activities may amount to an investment activity. The first point to consider is whether or not there is any identifiable activity distinct from the trading activity:

- *Whether the earnings are retained for the present and future cash flow requirements of the trading activity.*
- *The nature of the underlying investments used as a lodgement for the funds, for instance if the funds are locked into long-term investments or the investments themselves are high risk that may suggest that they are not available for the trading activity.*
- *The extent of the company's (or group's) activity in managing the investments.*
- *Whether the funds have been ear-marked for a particular use in the trading activity.*

If a separate investment activity is identified then it will become necessary to determine whether that is substantial in terms of the overall activities.

Whether or not making and holding investments are part of a company's, or group's, trading activities is a question of fact that can be determined only by reference to all the relevant circumstances."

For disposals made on or after 6 April 2019, the period throughout which the qualifying conditions must be satisfied is two years.

Adviser charging

The advice provided in relation to the investment will have to be paid for. This could come from the bond or simply as a payment from the company bank account. The latter is by far the simplest. If the payment comes in the form of a withdrawal from the bond there will be an 'event' and the profit (or loss) on the bond will have to be calculated.

Is the adviser's fee tax deductible in arriving at the company's taxable profit?

The test for deductibility is whether the expenditure has been incurred:

(a) wholly and exclusively for the purposes of carrying on the trade, and

(b) is income, as opposed to capital, in nature

Adviser charging in respect of a bond will usually fail (b) and will therefore not be tax deductible.

The HMRC Business Income Manual (BIM) supports this view at BIM 46415.

Transfers to employees or shareholders

The directors may want to consider transferring the bond to an employee or to a shareholder. This will be a taxable event and the company will suffer tax on the profit made at the time of the transfer.

If the transfer is made to an employee or director it will constitute employment income for the recipient individual. However, if the transfer is made to a shareholder it will rank as a distribution (dividend).

Is the transfer a reward for services? If it is, it will be employment income in the hands of the recipient. Or if it is a distribution of profit, it will be investment income in the hands of the recipient.

If the transfer is a reward for services there will be national insurance liabilities.

If the transfer is being made as a reward for services then the transfer value will qualify as a trading expense for the company and be deductible in arriving at its corporation tax profit.

If the transfer is a distribution of profits there will be no corporation tax deduction.

Basic rate credit

There is a mechanism in the rules impacting UK insurance savings bonds that broadly treats tax as being paid at a rate equal to the basic rate of income tax on non-trading credits on a related transaction. This special rule recognises that the insurer will have borne tax on the income and gains on the assets in the funds underlying the contract.

Where the company uses historic cost accounting, the non-trading credit (NTC) on the related transaction is treated as 'grossed-up' by an appropriate percentage rate (AR), that is, it is increased by NTC x AR/(100 – AR). The amount by which the NTC is increased is the amount of tax treated as paid.

AR is currently 20% (equivalent to the basic rate of income tax).

Slightly different rules apply where fair value accounting is used.

The special rule does not allow for tax treated as paid where an annual non-trading credit arises on a contract owned by a company that uses fair value accounting. However, it does take account of the earlier credit in allowing relief when there is a subsequent disposal of rights under the contract.

The amount by which the non-trading credit on the related transaction is grossed up and treated as tax paid is the contract profit (PC) x AR/(100 – AR).

Where the related transaction is the disposal of all the rights under the policy, PC is the profit from the contract defined as:

- the amount payable on the related transaction, less
- the fair value of the contract on the later of

  (a) the date that the contract was made, and

  (b) the start of the company's first AP to begin on or after 1 April 2008.

Where the related transaction is disposal of part of the rights the calculation of PC is similar, except that only the proportion of the fair value of the contract relating to the part disposed of is deducted. The proportion to be applied is C/FVC, where C is the amount payable on the disposal and FVC is the fair value of the contract immediately before the disposal.

Where tax is treated as paid, it may be set against the company's liability to corporation tax for the accounting period in which the related transaction arises. However, where it exceeds the company's liability to corporation tax, the excess is not repayable to the company and nor can it be offset against corporation tax in any other accounting period.

Let's look at an example

Alpha Ltd

Alpha Ltd (a micro-entity) has an accounting date of 31 December.

It took out a life assurance contract on 1 May 2016. The premium was £10,000.

It surrendered 25% of the contract on 1 September 2019 receiving £4,000.

There is a non-trading credit on the disposal calculated:

Proceeds **£4,000**

Cost **£2,500**
(25% x £10,000)

'Profit' **£1,500**

This is grossed up by £1,500 x 20%/(100 – 20%) = £375 and the non-trading credit of £1,875 is brought into Alpha's corporation tax computation.

Tax treated as paid of £375 can be offset against the company's corporation tax liability for this period.

Beta Ltd

Beta Ltd has an accounting date of 31 March. It uses fair value accounting.

It took out a life assurance contract on 25 August 2017. The premium was £20,000.

Beta Ltd surrendered 50% of the contract on 30 September 2019 receiving £12,000.

The fair value of the contract on the company's accounting dates was:

31 March 2018 **£22,000**
31 March 2019 **£21,500**
31 March 2020 **£12,750**

The fair value immediately before the part-surrender on 30 September 2019 was £24,000.

The relevant parts of the corporation tax computation will be:

Accounting period year ended 31 March 2018

Non-trading credit **£2,000**
(being growth in value to accounting date)

No tax is treated as paid as there hasn't been a disposal of contract rights.

Accounting period year ended 31 March 2019

Non-trading debit **£500**
(being fall in value over the accounting year)

Accounting period year ended 31 March 2020

A two part computation is needed:

(a) There is a non-trading credit in respect of the growth on the retained element of the contract

£12,750 – £10,750 = £2,000

(b) There is a non-trading credit in respect of the profit on the surrendered element of the contract.

£12,000 – £10,750 = £1,250

As there has been a disposal of contract rights tax will have been treated as paid.

PC (the contract profit) will be **£12,000 – £10,000 = £2,000**

The uplift in the non-trading credit is:

£2,000 x 20/(100-20) = £500

This is also the tax treated as being paid.

The 'complete' impact for the accounting period is:

Non-trading credits **£3,750**

Tax treated as paid **£500 (available for set-off)**

Companies investing in Authorised Investment Funds

Introduction

Authorised Investment Funds (AIFs)

AIFs are authorised and regulated under the terms of the Financial Services and Markets Act 2000 (FSMA). AIFs include authorised unit trusts (AUTs) and open-ended investment companies (OEICs).

AUTs and OEICs are collective investment schemes.

A collective investment scheme is a form of investment fund that enables a number of investors to 'pool' their assets and invest in a professionally managed portfolio of investments, typically gilts, bonds and quoted equities. Some investments, however, may be in unquoted investments or property. In effect, investors in such schemes are able to spread or reduce the risk that is associated with investment in such assets as well as gain the benefits of professional management. The reduction in risk is achieved because the wide range of investments in a collective investment scheme reduces the effect that any one investment can have on the overall performance of the portfolio.

Definition – FSMA 235. A collective investment scheme is defined as:

"...any arrangements with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements (whether by becoming owners of the property or any part of it or otherwise) to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income."

The arrangements must be such that the persons who are to participate, 'participants', do not have day-to-day control over the management of the property, whether or not they have the right to be consulted or to give directions.

The arrangements must also have either or both of the following characteristics:

(a) the contributions of the participants and the profits or income out of which payments are to be made to them are pooled,

(b) the property is managed as a whole by, or on behalf of, the operator of the scheme

Taxation of OEICs

OEICs do not pay UK tax on dividend income and capital gains made by OEICs are not taxable.

Company Owned OEIC – Corporation Tax

General Principles

Dividends received by UK companies are not subject to corporation tax.

Interest will be received gross and is taxable.

Company Investing In OEIC

Where an 'equity' fund pays a dividend to a company, the distribution is divided into that part which relates to dividend income of the fund and that part which relates to other income. The part relating to dividend income is not subject to corporation tax, and the other part is taxable. (The OEIC will issue a tax voucher showing the split).

If the company uses historic cost accounting, the OEIC investment will not be revalued at the end of each accounting period. When the fund is disposed of, the gain on an 'equity' fund after any indexation will be subject to corporation tax. If there is a loss, indexation will not enhance that loss. When a company makes a capital gain on or after 1 January 2018, the indexation allowance that is applied in order to determine the amount of the chargeable gain will be calculated up to December 2017.

If it is a 'debt' fund then no indexation is available to reduce the gain.

If the company uses fair value accounting, the fund will be revalued at the end of each accounting period.

There are no tax implications for an 'equity' fund but increases in a 'debt' fund will give rise to loan relationship non trading credits which will be subject to corporation tax.

When the fund is disposed of, the gain on an 'equity' fund after indexation will be subject to corporation tax. Please see above comments regarding gains made on or after 1 January 2018.

If there is a loss, indexation will not enhance that loss.

If it is a 'debt' fund then no indexation is available to reduce the gain.

How to extract profits from your business

There are three main routes for a business owner to extract profits from their own limited company or family firm, namely:

- salary,
- dividends and
- pension contributions (although this is taking money from the company for future use).

The other alternative is to leave the profit in your company and take the proceeds from the subsequent sale.

The key determination on this is the net benefit to the owner in terms of how they structure their payments. While no one likes making payments in tax or national insurance, if you could do this in a way that gives you the most benefit why would you not? Paying tax is not a bad thing if the end result is more money in your pocket, at the time you need it.

The simplest example on net benefit is a basic rate taxpayer making a pension contribution. If they are basic rate taxpayers at the time of taking the benefit they have effectively turned an £80 net contribution into an £85 net benefit (tax relief on the £80 net contribution will result in £100 into the pension, at the point of withdrawal 25% can be taken tax free and the remaining 75% is taxed at 20%). Knowing this, would you prefer to have 100% of the £80 and keep this in your bank account, or would you rather make a pension contribution and get 85% of £100, at some point in the future?

Whilst the above is a simple equation for an employed person with no access to a salary sacrifice or net pay arrangement, for the owner/operator of a limited company there are several factors to take into account that have the potential of making pension contributions even more favourable.

Taxation that will apply to a business owner when taking profit

In order to understand the impacts of the various methods, professional advisers need to engage SME business owner clients in a conversation on how profits can be taken from their business, how they are taxed and the effective rates of taxation that are applied. The following provides a client focussed explanation of the major points for consideration and may be useful in promoting this conversation.

Business

Corporation tax

Corporation tax is simply a tax on the profits of an incorporated business i.e. a LTD or a PLC. The rate was cut from 20% to 19% in 2017.

You can deduct the costs of running a business before profits are calculated, so employee payments (including to the business owner where they are also an employee), employers National Insurance and pension contributions (subject to the wholly and exclusively rule, details of which are available at **pruadviser.co.uk/knowledge-literature/knowledge-library/tax-relief-employer/**

Employer's National Insurance

Employers have to pay national insurance for their employees once their salary reaches certain thresholds. The rates that are paid can vary depending on an employee's age (the Upper Secondary Threshold introduced from April 2015 for employees under the age of 21). However, as most owner operators will not qualify for any differing rates, we will work on the assumption of the below rates for employers NI rates:

Category letter	£0 to £169 per week (£0 to £732 a month)	£169.01 a week to £962 a week (£732.01 a month to £4,167 a month)	Over £962.01 a week (over £4,167 a month)
A	0%	13.8%	13.8%

Therefore, from an employer point of view, any employee earnings over £8,788 will attract a NI payment of 13.8%.

Please note, the **employment allowance** which grants up to £4,000 a year of a company's National Insurance bill is likely not to apply to owners of a company, unless they have further employees. You cannot use the employment allowance if:

- you're the director and the only employee paid above the Secondary Threshold.
- you're a service company working under 'IR35 rules' and your only income is the earnings of the intermediary (such as your personal service company, limited company or partnership).

If you're part of a group, only one company or charity in the group can claim the allowance.

Find more details of the National Insurance rates and categories here **gov.uk/national-insurance-rates-letters**

Individual

Salary

This will be taxed as per any employee, you will a personal allowance which is £12,750 per annum in 2021/2022. Remember there is a reduction in the personal allowance for those with adjusted net income over £100,000 (personal allowance is reduced by £1 for every £2 of adjusted net income above £100,000, therefore those with adjusted net income of £125,000 or above will lose the personal allowance).

After the personal allowance is exhausted, earned income is taxed. This is now dependant on if an individual is liable to the Scottish Rate of Income Tax (SRIT) or the Welsh Rate of Income Tax (CRIT), further information on this can be found here:

pruadviser.co.uk/knowledge-literature/knowledge-library/scottish-rates-of-income-tax-facts

pruadviser.co.uk/knowledge-literature/knowledge-library/welsh-rate-of-income-tax-facts

	Non SRIT		SRIT	
	Rate	Band	Rate	Band
Starter Rate	N/A	N/A	19%	£0 – £2,097
Basic Rate	20%	£0 to £37,700	20%	£2,098 – £12,726
Intermediate Rate	N/A	N/A	21%	£12,727 – £31,092
Higher Rate	40%	£37,701 – £150,000	41%	£31,093 – £150,000
Additional Rate*	45%	Over £150,000	46%	Over £150,000
* Please note, additional rate tax has now been renamed Top Rate in Scotland				

Scottish taxpayers will pay the Scottish rate of income tax (SRIT) on non-savings and non-dividend (NSND) income. NSND income includes employment income, profits from self-employment (including sole trades and partnerships), rental profits, and pension income (including the state pension). Similarly, from 6 April 2019 Welsh Taxpayers will pay the Welsh Rate of Income Tax (CRIT (C for Cymru)) on NSND income.

Other tax and deductions such as Corporation Tax, dividends, savings income and National Insurance Contributions etc. will remain based on UK rules. This could mean the amount of income tax relief which can be claimed on pension contributions by Scottish and UK tax payers may not be the same.

For more info on SRIT and how this works in practice, please visit our **facts page**.

For more info on CRIT and how this works in practice, please visit our **facts page**.

Find out more in an article on the **personal allowance**.

Employees National Insurance

Much like the employer contributions above, the rates and amounts of employee NI contributions can vary, but for most employees they will fall into the following bandings:

Category letter	£0 to £183 a week (£0 to £792 per month)	£183.01 to £962 per week (£792.01 to £4,167 per month)	Over £962.01 a week (£4,167.01 a month)
A	0%	12%	2%

Dividends Received

Dividends are payments from company profits to shareholders.

Dividends from companies, unit trusts and OEICs are all taxed in the same way.

From 2016/17, dividend taxation as we knew it changed.

The dividend tax credit was removed and was replaced by the system detailed below.

There is now a dividend nil rate of taxation applied to the first £2,000 per annum (this reduced on 6 April 2018 from the previous £5,000 level). Thereafter dividends will be taxed as below;

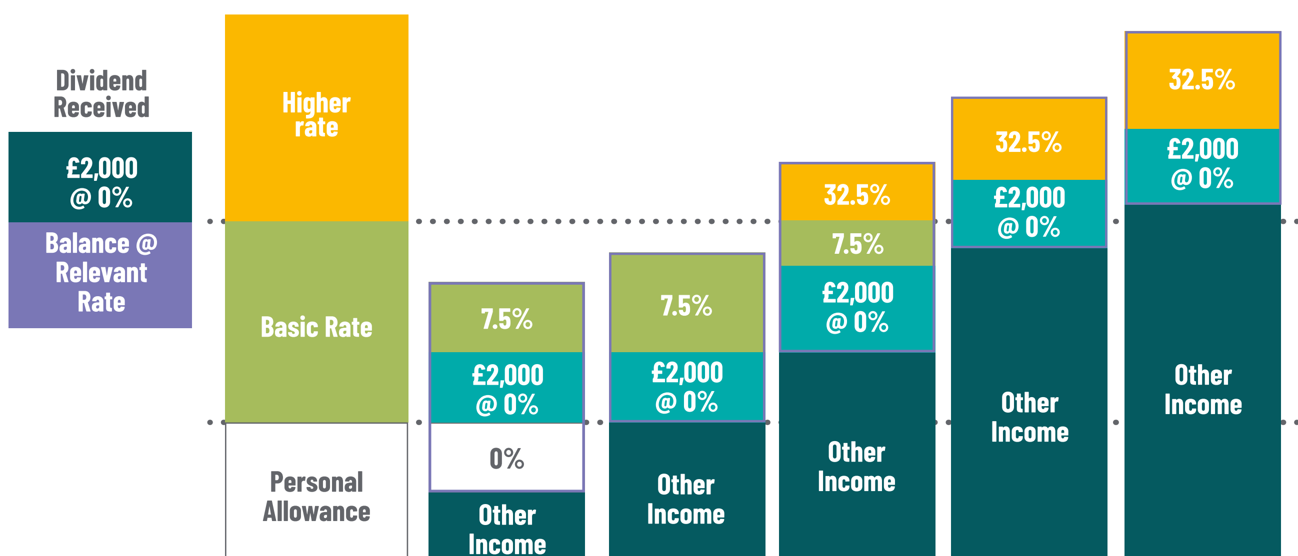
Basic Rate	Higher Rate	Additional Rate
7.5%	32.5%	38.1%

It's important to understand that the 0% is a starting rate of tax on the dividend and not a deduction on the amount of dividend received. For example, if an individual has fully used their personal allowance, is £1,000 below the higher rate threshold and receives £3,000 of dividends, £1,000 of the dividends would be taxable at the higher rate for dividends.

Note: it's the whole of the dividend payment that is included in the tax computation and not just the balance above £2,000. Although the first £2,000 is 0% rated, any balance will be taxed in the tax band in which it falls. Dividends can be set against any unused Personal Allowance before application of the £2,000 allowance. So effectively a person with no income can receive £14,500 in dividends before tax becomes payable.

The diagram below shows this in practice:

Dividend tax Allowance



So how can you get the profits out of your business in the most tax-efficient manner?

The simple answer to this is to make pension contributions. As detailed earlier, these do not suffer corporation tax or NI when these are made from the business, and when the benefits are taken 25% is usually tax free and thereafter taxed at the individual's marginal rates applicable at the point of withdrawal, with no NI to pay.

Whilst the most tax efficient, perhaps not the most practical solution!

Those under age 55 need an accessible source of income for living expenses.

Those over age 55 could, in principle, use immediate vesting pension contributions to provide their living expenses but in reality that's not likely (the recycling rules could come into play).

Is it worth the bother of the practicalities of paying and vesting a pension every year? In addition, accessing pensions in excess of any tax free cash triggers the Money Purchase Annual Allowance and as such may hamper the ability to fund a direct contribution pension in excess of £4,000.

For more information, see article on the **Money Purchase Annual Allowance**.

In any event, given the generosity of tax treatment would it not be wise for an individual to use their pension to fund needs in retirement using any available funds not required immediately?

So how can a client extract money from their business to meet day-to-day living costs both now and in the future? The table below shows a basic comparison between the three remuneration methods for the 2020/21 tax year, where £1,000 of payment falls wholly in the relevant tax or NI band and 25% tax free cash is taken from the pension.

		Corporation Tax	Employer National Insurance	Employee National Insurance	Income Tax (assuming 25% tax free cash)	Dividend Tax	Per £1,000 of business profit in your pocket	Percentage rate of taxation on the £1,000
Basic Rate	Salary	0.00%	13.80%	12.00%	20.00%	0.00%	**£597.54**	40.25%
	Dividend	19.00%	0.00%	0.00%	0.00%	7.50%	**£749.25**	25.08%
	Pension Contribution	0.00%	0.00%	0.00%	15.00%	0.00%	**£850.00**	15.00%
Higher Rate	Salary	0.00%	13.80%	2.00%	40.00%	0.00%	**£509.67**	49.03%
	Dividend	19.00%	0.00%	0.00%	0.00%	32.50%	**£546.75**	45.33%
	Pension Contribution	0.00%	0.00%	0.00%	30.00%	0.00%	**£700.00**	30.00%
Additional Rate	Salary	0.00%	13.80%	2.00%	45.00%	0.00%	**£465.73**	53.43%
	Dividend	19.00%	0.00%	0.00%	0.00%	38.10%	**£501.39**	49.86%
	Pension Contribution	0.00%	0.00%	0.00%	33.75%	0.00%	**£662.50**	33.75%

Scottish Rate of Income Tax

		Corporation Tax	Employer National Insurance	Employee National Insurance	Income Tax (assuming 25% tax free cash)	Dividend Tax	Per £1,000 of business profit in your pocket	Percentage rate of taxation on the £1,000
Starter	Salary	0.00%	13.80%	12.00%	19.00%	0.00%	**£606.33**	39.37%
	Dividend	19.00%	0.00%	0.00%	0.00%	7.50%	**£749.25**	25.08%
	Pension	0.00%	0.00%	0.00%	14.25%	0.00%	**£857.50**	14.25%
Basic	Salary	0.00%	13.80%	12.00%	20.00%	0.00%	**£597.54**	40.25%
	Dividend	19.00%	0.00%	0.00%	0.00%	7.50%	**£749.25**	25.08%
	Pension	0.00%	0.00%	0.00%	15.00%	0.00%	**£850.00**	15.00%
Intermediate	Salary	0.00%	13.80%	12.00%	21.00%	0.00%	**£588.76**	41.12%
	Dividend	19.00%	0.00%	0.00%	0.00%	7.50%	**£749.25**	25.08%
	Pension	0.00%	0.00%	0.00%	15.75%	0.00%	**£842.50**	15.75%
Higher (below rUK) ((£43,430-£50,000)	Salary	0.00%	13.80%	12.00%	41.00%	0.00%	**£413.01**	58.70%
	Dividend	19.00%	0.00%	0.00%	0.00%	7.50%	**£749.25**	25.08%
	Pension	0.00%	0.00%	0.00%	30.75%	0.00%	**£692.50**	30.75%
Higher (above rUK)	Salary	0.00%	13.80%	12.00%	41.00%	0.00%	**£500.88**	49.91%
	Dividend	19.00%	0.00%	0.00%	0.00%	32.50%	**£546.75**	45.33%
	Pension	0.00%	0.00%	0.00%	30.75%	0.00%	**£692.50**	30.75%
Higher (above rUK)	Salary	0.00%	13.80%	12.00%	46.00%	0.00%	**£456.94**	54.31%
	Dividend	19.00%	0.00%	0.00%	0.00%	38.10%	**£501.39**	49.86%
	Pension	0.00%	0.00%	0.00%	34.50%	0.00%	**£655.00**	34.50%

The higher rate for SRIT has been split owing to the differential for NI rates in the higher rate SRIT band. For UK NI moves to 2% annually at £50,000 which matches the UK higher rate of tax. This creates a differential in the effective rate of taxation as detailed.

Note – in the tables above the £1,000 is the business profit available for remuneration. As such to be paid as salary the employer must retain some of the profit to pay the employers NI so to achieve this only £878.73 can be paid as salary as £121.27 employers NI is due on this amount. The employee NI of 12% is due on this £878.73 (£105.45). So overall £226.72 is deducted in NI from the £1,000 profit (22.67%) in the basic rate band.

Using the above example, once basic rate income tax and employee National Insurance is taken from the £878.73 only £597.54 is received in the individual's bank account. So effectively this is an overall rate of taxation of 40.25%. As can be seen, based on the above and assuming that all available allowances have been used, then dividends 'beat' salary to meet immediate daily needs.

As can be seen, based on the earlier example and assuming that all available allowances have been used, then dividends 'beat' salary to meet immediate daily needs.

But the interaction between allowances and NI thresholds can greatly affect this. For instance, you can take a salary up to the personal allowance without paying income tax, but there would be employees and employers NI payable from 8,788

When planning for the business owner, should the aim be to minimise payments to HMRC and retain as much as possible for the owner? Ultimately the business owner has to extract enough profit to live on, so where is the 'sweet spot' for taking a combination of salary and dividends?

Is the answer taking a salary of 8,788, with the remainder as dividends? Perhaps. Given the nuances of the rates of taxation, thresholds and allowances, is the answer 'it depends'?

Salary	Rationale
£0 to £8,788	Any salary paid as this level has no income tax, employee or employer NI to be paid (these are all corporation tax deductible). Whereas dividends will not have a personal tax liability, but will have had corporation tax of 19% deducted first. Therefore salary wins here.
£8,788 to £9,500	Salary is paid without income tax being deducted, but it is liable to employee (but not employers) NI being deducted at a rate of 12%. Dividends again suffer 19% corporation tax. So salary wins again.
£9,500 to £12,500	Salary will again have no income tax deducted, but employees and employers NI will be deducted at an effective rate of 22.67%. Dividends again suffer 19% corporation tax. Dividends win here.
£12,500 to £14,500	Salary at this level will be liable to income tax, employees and employers NI, an effective rate of 40.25% (39.37% for SRIT). As the dividends so far used the unused personal allowance the £2,000 zero rate can be used in this range of remuneration. These are again taxed at 19% corporation tax and no individual liability exists. So dividends win again.

Beyond £14,500, it is safe to assume that all available allowances have been used, and as can be seen, dividends are the way to extract the monies for immediate expenses.

Should any unused profit left after satisfying the immediate income need and not needed by the business, be used to make pension contributions?

Unlike individual contributions, employer contributions are paid before deduction of both NI contributions and corporation tax. This means 100% of the profit is available to the business owner in future, usually only being subject to marginal rate income tax on 75% of the pension fund. Or, in other words, effective tax rates of 0%, 15%, 30% and 33.75% (or 14.25%, 15%, 15.75%, 30.75% or 34.5% for Scotland), depending on tax status in retirement. Given all the taxes for the company and the individual these are likely to be lower.

Why put the money away for the future if you are happy paying the dividend tax?

Some business owners would rather take the money out and have this in their current account so that they have total control on this – presumably they believe they don't control their pensions?

But if they saw the following example of how this would work for 2020/21, would they still have the same opinion?

John (who is not a SRIT tax payer) has a business and is taking profits from this in the form of dividends; he is a higher rate tax payer and is taking £1,000 net more than he needs each month to put in his bank account. Even if he could be convinced to give up £500 a month of this and put this into a pension then his situation would be greatly altered.

£500 a month equates to £6,000 per annum, grossing this back up with the higher rate of dividend taxation applied next year (32.5%) this means that the business needed to pay £8,888.89 gross for this to go to John.

But the above dividend payments can only be made after the business has paid corporation tax, so the total profits from the business needed to provide this dividend becomes £10,973.94.

Paying this £10,973.94 from the business to a pension would avoid immediate taxation (corporation tax and dividend tax in this case).

The Centre for Policy Studies research has estimated that 6 out of 7 higher rate taxpayers are not higher rate taxpayers in retirement. So assuming that John is a basic rate taxpayer in retirement, this would give him £9,327.85 (as per the benefit per £1,000 in the table on page 19).

If you asked John if he is willing to give up £6,000 a year in his current account that he presently does not need and instead have £9,327.85 in his bank account when he is retired, what would he say? He can't say we'll invest that money to get a better overall return, as most investments will be available in the pension.

But what about Business Asset Disposal Relief. Would it not be more efficient to leave the money in the business and benefit from this on the sale of the company?

Business Asset Disposal Relief is only chargeable at 10%. As such it would appear that this would be the most efficient way to extract the profit from the business (should the business qualify for this), as any profits left in the business when it is sold will only be taxed at 10%. So would that be cheaper?

It's important to remember that the profits retained by the business will have already been subject to corporation tax.

Therefore, all things being equal the retained profit is 'capital gain' and the Business Asset Disposal Relief effectively applies 10% taxation to 81% of each year's profit. So the effective rate of taxation is 27.1%, or to compare this to the table per £1,000 in the business you will receive £729 back.

As can be seen from the text above, if the business owner is likely to be a basic rate taxpayer in retirement, then pension contributions clearly win. For a higher rate taxpayer this results in a marginally higher rate of tax on the pension (30%), against 27.1% tax using Business Asset Disposal Relief. For an additional rate taxpayer in retirement this would appear to make no sense.

However, pensions have another distinct advantage. Many people see their business as their pension but having your business as your pension has many downsides, it is available to creditors, it may not be sellable at the right time etc.

In fact do any of your other clients have all their retirement funds riding on an investment in a single private equity? I'd suggest the answer to that is no.

So why let your business owner defy conventional planning logic? Having a pension and a business to fund your retirement helps diversify risk, make retirement more flexible with more options than having "business only". A plan B guarding against a failure of Plan A. For a higher rate taxpayer in retirement would they rather pay an extra 2.9% for that peace of mind or to have a plan B?

Taxation on death

Pensions are usually free of IHT on death and the taxation of the death benefits now normally revolves around where the member was aged under 75 at time of death. Pre age 75 the benefits are free of tax when these are paid to an individual; post age 75 death benefits are taxed at the marginal rates of taxation when these are paid to an individual.

Further information on this can be found in the following articles

Death benefits – defined benefits schemes article

Annuity death benefits article

Defined contribution schemes and death benefits article

Where the business owner dies when the business still has value, the Inheritance Tax Act 1984 provides relief for certain types of business or business property included in either a lifetime transfer or the deceased's estate. This may give 100%, or 50% depending on the nature of the company. Further information on this can be found at **pruadviser.co.uk/knowledge-literature/knowledge-library/business-property-relief-facts/**

It is important to note the section on excepted assets (including 'surplus cash'), as any excess cash not required for the purposes of the business may not get any IHT exemptions.

Conclusion

As can be seen there are a limited amount of options for extracting company profits.

Each of these has their own particular tax and national insurance consequence for the business owner with their employer and employee 'hats' on.

Whilst this can be technically complex is the planning not simple?

To ensure profits are extracted efficiently, business owners should extract the minimum amount of profit required to fill their current account for immediate needs using a combination of salary and dividends and the balance should perhaps be invested into pension to maximise their current account of the future? After all, should the business not work as hard for the business owner, as the business owner works for the business?

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