Nabarro
Chartered Accountants

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### TAX EFFICIENT EXTRACTION OF PROFITS

In his Summer 2015 Budget, the Chancellor announced far-reaching reforms to the way in which dividends are taxed. If you are the director of a personal or family company and extract profits in the form of dividends, this will affect you.

Under the rules as they currently stand, it is preferable from a tax and National Insurance perspective to operate as a limited company and to take a small salary to preserve entitlement to the state pension and certain contributory benefits and to withdraw additional profits in the form of dividends. Although dividends must be paid out of after-tax profits (once corporation tax has been paid), withdrawing profits as dividends has a number of advantages:

- no National Insurance contributions are payable on dividends; and
- the availability of the 10 per cent tax credit attaching to dividends means that there is no further tax to pay until taxable income reaches the threshold at which higher rate tax becomes payable (£42,385 for 2015/16). Thereafter, the effective rate of tax on the net dividend is 25% for a higher rate taxpayer and 30.6% for an additional rate taxpayer.

**What is changing**? From 6 April 2016 the 10% tax credit on dividends in being abolished. This means that it will no longer be necessary to gross up the amount of dividend actually paid to take account of this tax credit or to deduct the tax credit from the tax that you owe – the amount paid by your company will from 6 April 2016 be the gross amount of the dividend.

To compensate for this loss of tax credit, a new tax-free allowance of £5,000 will be available for dividends. Once this allowance has been used up, dividend income will be taxed at the appropriate dividend tax rate, which will be 7.5% for a basic rate taxpayer, 32.5% for a higher rate taxpayer and 38.1% for and additional rate taxpayer.

This means that anyone who currently has dividend income of more than £5,000 a year will pay more tax on their dividends from April 2016. It will no longer be possible to pay a small salary (covered by the personal allowance) and to then pay dividends until the higher rate threshold is reached without having to pay any further tax on those dividends. It will also be necessary to ensure funds are available to pay the additional tax that will be due on the dividends.

It is advisable to speak to your tax adviser as to how these changes will affect you and to discuss your optimal profit extraction strategy going forward. Although the new dividend rules do not come into force until 2016/17, it is also advisable to review your dividend

extraction strategy for 2015/16 as it may be beneficial to accelerate dividend payments to before 6 April 2016 to take advantage of the more favourable dividend tax rates applying before that date.

**Is a limited company still the best option?** You may also wish to consider whether operating through a limited company remains the best option for you.

Our general rule of thumb was that a limited company was beneficial for profits of around £40,000pa, based on the published information so far this level increases to £60,000pa.

However, before making a decision you may wish to see what the Chancellor does to Class 4 National Insurance contributions, which are payable by the self-employed on their profits. At the time of the March 2015 Budget the Chancellor announced his intention to consult on the abolition of Class 2 National Insurance contributions and the reform of Class 4 contributions to provide benefit entitlement. The consultation is expected later in the year. However, it should be noted that as things currently stand, disincorporation relief, which allows a company to transfer assets to its shareholders without triggering a tax charge, is only available where the transfer of assets occurs before 31 March 2018. If you are thinking of disincorporating, you may wish to do so before that date. Speak to your advisor to see if this is for you.

**One-man companies to lose employment allowance** It should also be noted that the National Insurance employment allowance will not be available to companies where the director is the sole employee from 6 April 2016 onwards. However for most one-man companies claiming the employment was not beneficial because of the additional employee national insurance and the bringing forward of tax payment dates.

## RETIREMENT PROVISION

As people live longer it becomes increasingly important to ensure that you have made adequate financial provision for your retirement. However, the rules are constantly changing and this makes planning ahead with any degree of certainty somewhat difficult.

**State pension changes** The state pension currently comprises the basic state pension and the earnings-related second state pension (also known as S2P). This two-tier state pension is payable to anyone who reaches state pension age before 6 April 2016, provided that their contributions record is sufficient. A person who reaches state pension age before 6 April 2016 will need 30 qualifying years in order to qualify for the full basic state pension.

Your state pension age depends on your date of birth and your gender.

The current two-tier state pension is being replaced with a single-tier state pension for people who reach state pension age on or after 6 April 2016. If you reach state pension age before this date you will continue to receive the current two-tier state pension. The introduction of the new single-tier state pension will not affect you. Under the new single-tier state pension, a person will need at least 35 qualifying years for the full single-tier state pension. Anyone with less than 35 qualifying years will receive a reduced pension depending

on the number of qualifying years that they have built up. However, a single-tier state pension will only be payable if a person has a minimum of 10 qualifying years.

**Topping up your pension** If you are unlikely to have enough qualifying years to earn a full state pension by the time that you reach state pension age, you may wish to pay contributions voluntarily to top up your record. Class 3 contributions are designed for this purpose. However, at £14.10 per week (2015/16 rate) they are quite expensive. If you have small earnings from self-employment (less than £5,965 for 2015/16) you may wish to pay Class 2 contributions voluntarily instead. At £2.80 a week, this is a much cheaper option.

If you are due to reach state pension age before 6 April 2015, from 12 October 2015 you will also have the option to make a Class 3A contribution to boost your pension. The amount of the contribution depends on how old you are when you pay it. Speak to your adviser to discuss whether making such a contribution is likely to be cost effective.

**End of contracting out** The changes to the state pension mean that from 6 April 2016 it will no longer be possible to build up entitlement to the second state pension. The second state pension is only paid to those who reach state pension age before 6 April 2016 and who have earned entitlement to it. As a result, the ability to contract out will end on 5 April 2016. If you are currently in a contracted-out salary-related pension you will need to pay full rate National Insurance contributions from 6 April 2016. Your adviser will be able to explain how this will affect you.

**Pensions tax-relief** Individuals are able to make tax-relieved pension savings to registered pension schemes. However, contributions only attract tax relief to the extent that they do not exceed the annual allowance. The allowance can be carried forward for up to three years if it is not used up. The allowance was set at £40,000 for 2015/16 and at £50,000 for 2014/15 and 2015/16.

The Chancellor announced various changes which affect the annual allowance in his Summer 2015 Budget.

Pension contributions are measured against a pension input period to check that the annual allowance has not been exceeded. This does not currently have to correspond with the tax year. However, from April 2016 the pension input period will be the tax year. For 2015/16 only, the pension annual allowance is increased to £80,000, but this is subject to an allowance of £40,000 for the period from 9 July 2015 to 5 April 2015. The rules are quite complicated so speak to an advisor to find out how you can make the best use of your available allowance for 2015/16.

**Reduced annual allowance for high earners** From 2016/17, the annual allowance for those with incomes (including pension contributions) of over £150,000 is reduced by £1 for every £2 by which their income exceeds £150,000. The maximum reduction is £30,000 so that an individual with income of £210,000 or above will have an annual allowance of £10,000 for 2015/16.

**Reduced lifetime allowance** The maximum amount of tax-relieved pension savings that a person can build up over a lifetime is capped by the lifetime allowance. This is to be reduced

from the current level of £1.25 million to £1 million from 6 April 2016. If your pension benefits are approaching this limit, speak to your adviser about protecting the benefits you have built up from future tax charges.

## HELP WITH CHILDCARE COSTS

Childcare costs are expensive and any help towards those costs is welcomed. Under the current system, tax exemption provides a measure of relief for those who receive childcare vouchers or childcare support from their employers. In most instances, the relief is now worth £11 a week to those lucky enough to benefit.

This system is to be replaced with a new system under which the Government will top up contributions made into an online account at the rate of 20p for every 80p paid into the account, up to a maximum top-up of £2,000. This top-up is tax-free and as it is not provided by the employer it is available to working parents (including the self-employed) as long as they earn an average of £50 per week and not more than £150,000 a year.

The new system was originally intended to be introduced from Autumn 2015. However following a legal challenge, the start date has now been delayed until 2017.

## STRUGGLING TO PAY YOUR TAX

Anyone struggling to pay their tax bill may be able to agree a time to pay agreement with HMRC. This should be agreed with HMRC before date on which the tax is due to be paid.

Although HMRC have always preferred to set up a direct debit arrangement when agreeing a time to pay arrangement, this will be mandatory from 3 August 2015. However, HMRC will not revisit existing arrangements where a direct debit mandate is not in place.

If you are likely to struggle to pay a tax bill, speak to your tax advisor who can help you come to an agreement with HMRC.

*This newsletter deals with a number of topics which, it is hoped, will be of general interest to clients. However, in the space available it is impossible to mention all the points which may be relevant in individual cases, so please contact us for personal advice on your own affairs.*

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