SUMMER 2014

Extracting Cash From Companies – Salaries And Bonuses

A company pays corporation tax on its profits, at 20% on the first £300,000, 21.25% on the next £1.2 million, and 21% on profits over £1.5 million. If the shareholders or directors want to take any cash out of the company, they will be taxed on what they take.

The simplest and most obvious way to extract cash is for the company to pay a salary to its directors, or perhaps a bonus at the end of the year, or both.

Such payments must be subjected to tax and National Insurance contributions (NIC) under the Pay As You Earn (PAYE) system, just like payments to any other employees. In addition to deducting tax and NIC, the company has to pay employer's NIC at a rate of 13.8% on payments over £7,956 per year.

This level of pay is also below the threshold at which income tax has to be deducted (assuming the individual concerned has a normal PAYE code).

In a case where the company is the sole source of income for the shareholder directors, it generally makes sense for the company to pay a salary just below this level to them. This is because salaries and bonuses paid to employees or directors of the company are normally allowed as a deduction from its profits for the purposes of corporation tax.

As far as the director is concerned, the £7,956 is taxable, but no tax will be deducted because it is below the PAYE threshold. At the end of the tax year, however, this pay will be taken into account when calculating the overall tax bill for self-assessment purposes.

Is it worth paying higher salaries to the director/shareholders? This is a very complicated question, and one where there is no substitute for doing the arithmetic in each case. However, as a very broad rule of thumb, it is likely that less tax will be paid overall (by the company and by the directors taken together) if further cash is extracted by other means. This is because the company has to pay employer's NIC at 13.8% on all such payments.

The arithmetic becomes complicated however, because the company can get a tax deduction for the payment to the director, including the employer's NIC. An example will show how this works, and that in most circumstances, dividends cost less in tax than salaries.

Example

Assume the company pays corporation tax at 20% and the director/shareholder is a 40% taxpayer.

If a company has a profit of £10,000, it can pay a total of £9,718 to the director – the other £282 is needed for the employer's NIC, but it will pay no corporation tax because it can deduct the payment and the employer's NIC from its profits. The director will pay income tax and NIC at 42%, leaving him with £5,636 in his pocket.

If the company decided to pay a dividend instead, it could only pay £8,000 because the remaining £2,000 is needed to pay corporation tax – dividends cannot be deducted for corporation tax purposes. The director will pay £2,000 income tax on the dividend, leaving £6,000 in his pocket.

Practical Tip:

In this case, paying dividends is clearly the best option (to the tune of £364), but there are so many variables that the basic proposition – salary up to the PAYE threshold, and dividends thereafter, should always be tested in the particular circumstances of the company in question.

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Directors' Loans – Dividend 'Trap'

In a personal or family company scenario, the directors often borrow money from the company. Although this can be useful, tax issues arise where the loan remains outstanding nine months and one day after the end of the accounting period.

Loan not repaid

If the loan is not repaid within this timescale, details of the loan must be included within the company tax return and the company must pay corporation tax at 25% of the balance of the loan. The tax is due on the normal due date for corporation tax. Interest is charged to the extent that the tax is paid late.

Repaying the loan

By contrast, if the loan is repaid before the corporation tax due date there is no corporation tax to pay on the loan balance.

There are various ways of clearing the loan, such as introducing funds into the business, writing off the loan, paying a bonus to clear the loan or declaring a dividend. If there are sufficient retained profits to declare a dividend, at first sight this might seem like a good solution.

Anti-avoidance trap:

New rules broadly mean that the repayment may be ineffective in cancelling out the tax charge if a new loan is taken out within 30 days of the repayment, or if at the time that the repayment is made arrangements are in place for a further loan or advance.

Beware the dividend trap

The extent to which declaring a dividend to repay a director's loan in order to avoid having to pay corporation tax on the loan balance is a good idea or not depends on whether the director is paying tax at the higher rate. If he is (and assuming he doesn't have the funds available to introduce into the business to clear the loan), it may be better for tax to be paid on the loan, rather than it being cleared with a dividend.

Repayable tax v non-repayable tax

Relief can be claimed for the corporation tax payable on the outstanding loan balance when the loan is eventually repaid (or otherwise cleared), but any higher rate tax paid on the dividend is non-refundable.

The corporation tax paid in respect of the loan can be reclaimed nine months after the end of the accounting period in which the loan was repaid. The claim must be made within four years of the end of the financial year in which the loan is cleared.

Example – Avoiding the dividend trap

Bill is the director of his own personal company (which is a close company). His year end is 31 May. At 31 May 2013, he has a director's loan account outstanding of £50,000.

Bill's corporation tax due date for the year to 31 May 2013 is 1 March 2014. He reviews his financial position in February 2014.

He has sufficient retained profits to declare an interim dividend before 1 March 2014 to clear the loan to save paying any tax on the outstanding loan balance. However, he is already a higher rate taxpayer in 2013/14. Assume he pays a net dividend of £50,000 to clear the loan he will have to pay income tax on the dividend of £12,500. This is due by 31 January 2015 and is non-refundable.

Alternatively, the company can pay the tax on the outstanding loan, also £12,500. Although this is due earlier (on 1 March 2014), it can be reclaimed once the loan is repaid (but note that there may be personal tax implications for Bill on the benefit of the loan, if it remains outstanding).

Practical Tip:

If there is the possibility of repaying the loan in the future or declaring a dividend to clear it when the director is a basic rate taxpayer, it may be better to leave the loan outstanding.

Property Deposits – What Is The Tax Treatment?

It is the usual practice to require a tenant to pay a deposit to the landlord when moving into a property. At the end of the tenancy, the deposit is returned, subject to deductions for 'dilapidations'.

Tenants are normally responsible for maintaining and repairing the interior of the property, and if at the end of the tenancy they have failed to do so then the tenant and the landlord will negotiate how the situation is to be dealt with.

Normally, the negotiation will take the form of agreeing how much of the deposit is to be returned to the tenant, with the balance retained by the landlord to cover the cost of the dilapidations.

Deposit schemes

In the case of assured short hold residential tenancies, with very few exceptions, the treatment of the deposits paid by tenants is governed by statute. The landlord is required to protect the tenant's deposit by using one of two types of government approved 'deposit protection schemes'.

In a **custodial** scheme, the deposit is paid to the scheme, and at the end of the tenancy the deposit is returned to the tenant – subject to some or all of it being paid to the landlord to cover dilapidations.

In an **insured** scheme, the landlord retains the deposit, but pays insurance premiums to the scheme to protect the tenant's interests.

Tax treatment

The tax treatment of deposits for landlords follows the normal principles of accountancy. When the tenant moves in and pays his deposit, the landlord has no right to the deposit money. He only becomes entitled to some or all of it at the end of the tenancy, when he may be allowed to retain part or all of the deposit to cover dilapidations.

Deposits received are income of the landlord's property business, but this income should be 'deferred' until the end of the tenancy. The principle of 'deferred' income applies where the recipient of the income has not done whatever is required to 'earn' that income.

In the case of a landlord, the deferral will continue until the landlord acquires (by agreement with the tenant or in cases of dispute, by the intervention of the Deposit Protection Service) the right to retain some or all of the deposit to cover dilapidations – or possibly, unpaid rent. At that point, the amount of the deposit retained is brought in as income, and the cost of making good the dilapidations is an expense.

This applies whether or not the landlord re-lets the property. Even if the landlord moves into it himself or sells it untenanted, the deposit was income (albeit deferred income) when he received it and it does not change its character as a result of him deciding not to re-let the property.

It should be noted that if the cost of the dilapidations is greater than the deposit, and if the tenant pays the landlord compensation for them in addition to forfeiting all the deposit, the tax treatment is different if the property is not re-let. In that case, the additional payment is likely to be treated as a capital receipt (giving rise to a capital gain), because it is compensation for the reduced value of the property as a result of the dilapidations.

If the property is re-let, then the additional sum paid is treated as income and the cost of making good the dilapidations is an expense.

Practical Tip:

Make sure you do not include deposits as part of the income of your property business until the end of the tenancy concerned, and then only to the extent that you do not return the deposit to the tenant.

Personal Tax

Claim A Deduction For Mileage Payments

Under the Approved Mileage Allowance Payments (AMAP) Scheme employers can pay employees tax-free mileage rates when they use their own car for business. Provided that the amounts paid do not exceed the rates set by HMRC, no tax liability arises and there is nothing to report on the P11D.

However, many employees are unaware that if their employer pays them at a rate that is less than the approved rate they can claim a tax deduction for the shortfall. The approved rates for 2014/15 for cars and vans are 45p per mile for the first 10,000 business miles in the tax year and 25p thereafter.

Case Study:

Nigel uses his own car for work and in 2014/15 undertakes 9,000 business miles. His employer pays a mileage allowance of 30p per mile. Thus, Nigel receives mileage allowances of £2,700 during the year.

However, at the approved rate of 45p per mile for the first 10,000 business miles, John's employer could pay him a tax-free allowance of £4,050 (9,000 miles @ 45p per mile). This is known as 'the approved amount'.

Nigel can claim a tax deduction of £1,350 for the shortfall between the approved amount (£4,050) and the amount he is actually paid (£2,700). Assuming Nigel is a higher rate taxpayer paying tax at 40%, this will save him tax of £540.

Property Tax

Interest On Portfolio Mortgages

Tax relief is allowed on interest paid on mortgages/loans taken out to finance the purchase of assets held within a business. Landlords who own two or more properties are deemed to own a 'portfolio' of business assets.

Lenders have designed products that treat the 'portfolio' as one single business account regardless of the number of properties purchased or whether the full amount of capital has been utilised. The individual properties may have separate mortgages each with different interest rates charged but the 'portfolio' is treated as one single business account.

One portfolio means one agreement, one monthly payment and one mortgage statement.

Should not all of the capital be used, tax relief on interest payments made remains fully allowable because the original reason for the mortgage/loan remains – namely to finance the use of capital by a property business.

Case Study:

Avril owns six properties with a total value of £2m. With a portfolio mortgage outstanding of £1.7m there is a 'shortfall' of £300,000. This amount is not the equity found in any one property but in the portfolio spread over the six properties. This allows £300,000 for further investment; the interest will be fully tax deductible.

Business Tax

Cap On Income Tax Reliefs

From 6 April 2013 a limit is placed on the amount that an individual may deduct by way of certain specified reliefs. The limit is set at £50,000 or 25% of the individual's adjusted total income for the tax year if this is greater.

The reliefs subject to the limit include income tax loss reliefs, but not charitable donations and contributions to registered pension schemes.

Where reliefs available for the year exceed the limit, care should be taken to ensure that maximum relief is obtained subject to the cap, such as carrying back losses to the previous year or carrying trade losses forward, rather than relieving in the current year. It is advisable that professional advice is sought.

Case Study:

Geoff has income for 2014/15 of £180,000. He makes a trading loss of £60,000. He had no income in 2013/14.

Geoff wishes to set the loss against his general income of 2014/15. However, the relief available for that year is capped at £50,000 as this is greater than 25% of his income (£45,000).

He can claim loss relief of £50,000 for 2014/15. As he had no income in 2013/14, he cannot carry the remaining £10,000 of the loss back. Therefore he must carry it forward for relief against future profits.

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