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CHARTERED ACCOUNTANTS

PROFIT EXTRACTION AND THE 2016 BUDGET

In a nutshell

For business owners considering how best to extract profits from their companies, the 2016 budget adds further challenges to those created by the changes announced last year. From 6 April 2016, these measures already threaten many business owners with an apparent rock and a hard place scenario, leaving them to choose between higher dividend taxes or capital payments at risk of being treated as dividends on liquidation.

- The 2016 budget makes profit extraction harder in the short term by shaving the benefits off loans to business owners, currently used as an alternative means of extracting proceeds. The rise in tax on such loans from 25% to 32.5% renders this option no better than the dividend tax rate for the 40% taxpayer.
- Despite legislation aimed at preventing business owners from turning to capital gains payments to avoid the higher dividend tax, the Government has announced a reduction in capital gains tax rates by 8% for both higher and basic rate payers.
- The entrepreneurs' rate remains unchanged at 10% but a softening of the rules means a wider range of entrepreneurial endeavours will benefit from this form of relief.

1. Loans to participators

With the increased tax rate on dividends announced last year coming into effect on 6 April 2016, business owners looked at deferring dividend payments and potentially liquidating their companies in order to withdraw proceeds as capital instead. However, the anti-avoidance legislation also announced last year, which comes into effect after 5 April 2016, has made this route much riskier: it renders a wider range of capital payments vulnerable to treatment as dividend income - and thus to the higher tax rate - on liquidation.

So it is not surprising that many business owners have looked to a third option for profit extraction: taking a loan from their company. Until the 2016 budget, this was a viable option. Loans from close companies, as most owner- managed companies are, do have a tax cost. Although part of the tax cost comprises the benefit in kind arising from interest free loans or loans at rates below the HMRC approved rate, the bulk of the cost is a 25% tax on the loan if it is not repaid within nine months of the company's year end. That said the tax is repayable when the loan is repaid. So with the arrival of higher dividend rates, and assuming this rule remains unchanged, a loan was - until this month - an attractive option for many businesses. However, the 2016 budget has increased the 25% tax charge to 32.5%, rendering the loan rate equivalent to the dividend tax rate for the 40% taxpayer, making it much less appealing. On the other hand, the 45% taxpayer, or the 40% taxpayer at risk of losing their personal allowance, can still reap benefits from this route.

2. Capital gains tax rates

While the Government is strengthening anti-avoidance legislation to prevent people from taking advantage of the differential between income and capital tax rates, the budget actually proposes to enlarge that differential by proposing a reduction in capital gains tax rates.

As of 6 April 2016, capital gains tax rates will fall from 28% (for a higher/additional rate payer) and 18% (basic rate taxpayer) to 20% and 10% respectively. Certain items such as residential property (a target for Government at the moment) and carried interest are excluded.

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3. Entrepeneurs' tax relief

The rate of entrepreneurs' relief remained unchanged at 10%. However, its scope has been extended to include subscribers for shares in unlisted trading companies even if the individual concerned is not a director or employee of the company. Rules have also been softened to make it a little easier to claim entrepreneurs' relief on disposal of goodwill on incorporation of a company. Joint ventures or partnership structures are also now included.

4. Conclusion and Recommendations

There is no doubt that the changes outlined above make profit extraction a more complicated issue for the business owner in the short term, particularly while the various changes take effect. Profit extraction is an issue that is closely linked to the circumstances of the individual business and its owner. Therefore two companies with similar ownership structures and profits could reach very different conclusions, when selecting the best profit extraction mechanism is for the owner manager. Therefore it is critical to consider what is best for the individual business owner and their business, taking professional advice where appropriate.

Whatever the ownership structure, whatever the profits, the 2016 budget poses a number of important questions to any business owner thinking about extracting profit from their company. These include:

Q: Should I pay a dividend before 6 April?

A: If your company is in a position to pay a dividend, paying it now would enable you to benefit from the lower dividend tax rates. However, bear in mind that this would have cash flow implications for the individual. It would mean that dividend income would be received in the 2015/16 tax year rather than in the 2016/17 tax year, bringing taxpayment dates forward a year.

Q: Should I pay a dividend or bonus after 6 April?

A: Increased tax rates on dividends will reduce the difference that currently favours dividend payments when deciding between bonus and dividend for the owner manager. However whilst reduced, the difference, in many cases, will still favour dividend payment compared to bonus.

Q: Should I pay dividend or capital?

A: Those owners considering an exit from their company in order to take proceeds (whether from liquidation or sale) as capital face an increased risk that these proceeds will be classified as dividends, if the exit occurs after 5 April 2016. Any business owner planning to exit after 6 April will need to consider the strengthened anti-avoidance legislation to establish clear arguments for continuing to claim capital treatment on exit.

For business owners who cannot claim entrepreneurs' relief, there may be a clear benefit to delaying disposal until after 5 April 2016 when lower capital grains tax rates could be available (if not at risk of being targeted as a dividend payment by HMRC).

Q: What are the alternatives to dividends?

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A: Alternatives could still include loans from the company, which, despite the increased tax charge on loans to participators, will in some cases still be an attractive way of benefitting from funds in the company. As pension relief escaped further scrutiny in the budget, pensions could also continue to be a useful profit extraction method for some owners.

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