Taylor Money. Wealth Management

Company pension contributions that "pay dividends"

We often encounter successful business owners with growing cash balances in their company. A healthy amount of cash in any business is sensible as it can help fund emergency expenditure, growth and expansion. Beyond this however, accumulating cash can become inefficient and a great deal of thought is often given as to how best to draw some of this hard-earned profit from the company. Whilst the most common way to realise money from a business is to draw income via salary or dividends, this can also be inefficient due to the gradual loss of one's personal allowance once personal taxable income exceeds £100,000.

In line with the above, one of the most common questions business owners come to us with is: ***How can I tax-efficiently draw monies out of my business for my benefit?*** The answer, almost always, starts with considering company pension contributions.

Unlike personal pension contributions, contributions paid directly from a trading company are paid gross and can be treated as a business expense. Furthermore, everyone starts with an annual personal pension allowance of £40,000* and can carry forward up to three years of unused allowance. This equates to a potential contribution of up to £160,000 in 2018/19.

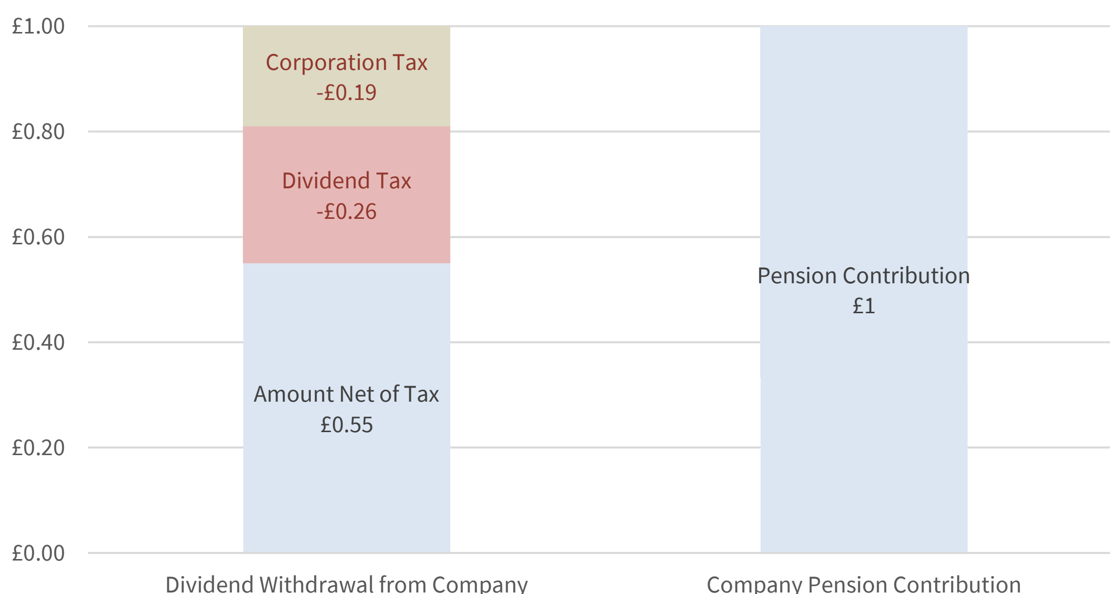
Consider the following example and chart which illustrate just how tax-efficient these contributions can be compared to being drawn as a dividend:

Dividend Income

Every £1 of profit made in a limited company is subject to corporation tax at 19%, leaving 81p. When that 81p is drawn as a dividend, assuming that the director is a higher rate tax payer, it will be taxed as income by a further 32.5%. This reduces net profit of 81p to 55p. In total then, £1 of profit dramatically reduces by 45% to just 55p when drawn as a dividend from the business.

Company Pension Contribution

If £1 of profit is instead paid by the company into a pension, it can be treated as a company expense and ***no corporation tax*** is due. Furthermore, there will be ***no income tax*** meaning that the pension receives the full £1. Therefore, by opting to make a company pension contribution instead of drawing a dividend, 55p has turned into £1. This uplift is equivalent to a 6.16% compounded return over 10 years and is quite incredible when you consider that unlike Venture Capital Trusts or Enterprise Investment Schemes, those monies do not have to be invested in any particularly high risk or unusual investment strategy.



Based on the figures above, a company making a £100,000 contribution on behalf of a director would result in an effective tax saving of at least £45,325.

The benefits don't stop there. Under current rules, pensions do not form part of your estate which can make them an effective estate planning vehicle and whilst in your pension can grow free of any tax. Furthermore, when you come to draw funds for retirement, you are entitled to draw 25% of the fund tax-free**. There is potentially some tax to pay later as funds drawn in excess of tax-free cash are taxed as income at your marginal rate however you have complete flexibility to ensure that any such income is drawn in a tax-efficient manner. For example, we aim to position a client's income so that they remain within the basic rate band throughout retirement where possible by using various investment wrappers.

In summary, company pension contributions remain one of the last ways to enjoy a truly risk-free return. As such, when directors are looking at tax-efficient ways to draw money from their business, this option should be very near the top of their agenda.

**In some circumstances this can be impacted/reduced where taxable income is in excess of £110,000.*

***Usually, subject to a maximum of 25% of the lifetime allowance relevant to that individual.*

Disclaimer: This article was written to provide clear information regarding potential financial planning opportunities and does not constitute advice. Client circumstances vary, and we advise each client on an individual basis. The information is based on current tax rules and legislation which is subject to change. The value of investments, and the income from them, may fall or rise and you might get back less than you invested.