Oury Clark
(44) 1753 551111

Salary or dividend?

When is it beneficial for a company owner or director to take a dividend rather than salary?

Many people running businesses prefer to do so through a limited company rather than as a sole trader. One reason is that the company pays corporation tax at rates of 20% or 21% against income tax rates of up to 45% for a sole trader. The company can therefore shelter profits at a lower rate of tax.

This is fine until the business owner wishes to extract profits from the company for his or her personal use. A payment of a salary or bonus, for example, often increases the overall amount of tax. Paying a £100 bonus from a company to its director saves perhaps £20 in corporation tax but could mean the director pays £40 or even £45 in income tax, thus increasing the overall tax bill by £20 or £25.

In addition, payment of salary can mean payment of national insurance (NI). The employer must pay NI, regardless of the age of the director, which is usually charged at 13.8% on all income above the earnings threshold, without limit.

If under statutory retirement age, the director pays NI at 12% on earnings between the earnings threshold and upper earnings limit, and at 2% above the upper earnings limit.

Salary is deductible from total profits whereas dividends are not.

Higher, basic and additional rate taxpayers

Let's compare the 2 methods. In each case, the director wants to extract £100 from the company before tax.

The director pays income tax at the 40% **higher rate** and is below the state retirement age. The company is liable for corporation tax at the small profits rate of 20%.

Salary (£)		Dividend (£)	
Gross profit taken	100.00	Gross profit taken	100.00
- Employer's NI (13.8/113.8)	12.13	- Corporation tax (20%)	20.00
Gross remuneration	87.87	Net dividend	80.00
- Tax (40%)	35.14	- Additional income tax (25% effective rate)	20.00
- NI (2%)	1.76		
Net remuneration	**50.97**	**Net dividend**	**60.00**

In the example, the overall tax rate has reduced from about 49% to 40%.

Salary or dividend?

Let us now consider the position for a director who is liable to pay only the **basic rate** (20%) of income tax.

Salary (£)		Dividend (£)	
Gross profit taken	100.00	Gross profit taken	100.00
- Employer's NI (13.8/113.8)	12.13	- Corporation tax (20%)	20.00
Gross remuneration	87.87	Net dividend	80.00
- Tax (20%)	17.57	(No additional income tax)	
- NI (12%)	10.54		
Net remuneration	**59.76**	**Net dividend**	**80.00**

And for an **additional rate** (45%) taxpayer:

Salary (£)		Dividend (£)	
Gross profit taken	100.00	Gross profit taken	100.00
- Employer's NI (13.8/113.8)	12.13	- Corporation tax (20%)	20.00
Gross remuneration	87.87	Net dividend	80.00
- Tax (45%)	39.54	- Additional income tax (36.11%)	28.88
- NI (2%)	1.76		
Net remuneration	**46.57**	**Net dividend**	**51.12**

In each case, dividends produce a higher net figure for the taxpayer than salary. But this does not mean that all shareholder/directors should extract profits as dividends.

It is possible that a shareholder/director may not be a taxpayer at all. For example, a person who sets up in business from a large redundancy payment may have no immediate need of income.

Many small companies are established with a small share capital and where the real funding is in the form of directors' loan accounts. These can be repaid tax-free as the company is simply giving the director's money back to him or her.

Also, if the employee earns less than the earnings threshold for NI, there are no deductions for tax and national insurance, so salary becomes the lower-taxed option.

Other factors to consider

It is not as simple as saying that dividends are always preferable to salary for taxpayers. There are other factors that need to be considered.

❶ **Paying dividends may not even be possible.** Dividends may only be paid out of profits. This is construed widely to include profits retained from previous years, capital gains and even revaluation surpluses. But it does not include share capital or loan capital. So paying dividends may not be possible for a start-up company that has yet to earn profits.

Sometimes directors seek to get round this by keeping some business fixed assets as personal assets and charging rent. Rent can be paid regardless of profits being earned provided there is sufficient cash in the business. However, this route can create further issues regarding business property relief for inheritance tax and entrepreneurs' relief for capital gains tax.

❷ **The director may prefer to remain an employee for non-tax reasons.** For example, in a small speculative venture the director may wish to keep open the option of claiming jobseeker's allowance should the business fail. This can only be done by remaining an employee and being paid at least the lower earnings limit for NI purposes. This also maintains entitlement to other benefits such as state second pension and statutory maternity pay.

❸ **There are some circumstances when a taxpayer can have a marginal rate of income tax greater than 45%.** This happens in 3 circumstances:

1. On the band of earnings between £100,000 and £120,000 where the personal allowance is progressively reduced to 0.
2. If the taxpayer is paying high income benefit charge on total income between £50,000 and £60,000. This charge can increase the marginal rate of income tax to more than 50% if the taxpayer has 2 children.
3. If the taxpayer is receiving any means-tested benefit, such as tax credit or universal credit, increase in income (whether salary or dividend) can result in high withdrawals. If the withdrawal of benefit is considered as the equivalent to tax, the rate can easily exceed 70%.

Ask for our advice

The choice of how to extract money from a company can have a significant effect on the total amount of tax paid.

If you are a director-shareholder, contact us so that we can make tax-efficient recommendations that are right for you.