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Tax	Dividend v Salary	Tony Jenkins

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Dividend v Salary

1. Introduction

The extraction of profit in family and owner managed businesses is a crucially important matter which has many considerations. Although there are a number of different methods of extracting profits from an owner managed business or company which are listed below the commonest decision is that between dividends and salary (or bonus). This module considers the issues.

2. Background

It is now more common for a family business to be operated through the medium of a limited company rather than through a partnership or on a sole-trader basis. The number of family companies swelled in part due to a wave of tax-geared incorporations in the early 2000s.

Low rates for companies paying corporation tax at the small profits rate (which is now, since 1 April 2015, the rate for all companies), combined with the favourable income tax and NIC treatment of dividends as compared to salary, meant that for many businesses it was tax-efficient to incorporate and to extract profits by means of dividends rather than as a salary.

Although subsequent changes in the relative rates of income and corporation tax slowed the pace of incorporations, the reduction in corporation tax rates and the increase in the rates for National Insurance Contributions from 2011–12 should ensure that the limited company remains the medium of choice when considering how best to carry on the family business.

There have been recent changes with the abolition of the small profits rate and marginal relief and corporation tax rates are being reduced gradually with the rate of 19% for Financial Years 2017, 2018 and 2019 with a further reduction to 17% in Financial Year 2020. These all contribute to the current decision.

Directors and shareholders in family companies have the freedom to choose how much money they take out of a company and the way in which that money is extracted. Value can be taken out of a family company in a variety of ways and the issue of tax efficient profit extraction encompasses more than the dividend versus salary debate.

Other profit extraction strategies include:

- paying interest on current account balances,
- paying contributions into a registered pension scheme,
- receiving loans from the company or
- by letting the company use personally-owned property and charging rent.

3. Salary v dividend

For most family businesses the standard approach has been to incorporate the business and extract the majority of profits by way of dividend payments. A typical set up is for the husband and wife to own the shares equally and for each to be paid dividends up to the higher rate tax threshold. This approach applies equally to civil partners. Involving other family members in the company and paying dividends to mop up their basic rate band will increase the amount of profits that can be extracted without further income tax being payable.

To retain state pension and benefit entitlement, a small salary is paid that falls between the lower earnings limit and the primary earnings threshold for NIC purposes. National Insurance is payable at a notional zero rate where earnings are between those limits, which allows state pension entitlement to be preserved for zero NIC outlay. The impact of the new £3,000 employer allowance is considered later.

It is also necessary to consider the impact of the minimum wage legislation. Although directors are generally outside the scope of the minimum wage, spouses or civil partners who are employed by the company and who are not themselves directors fall within its ambit.

Dividends are paid out of after-tax profits. This means that any money paid out by way of a dividend will have already suffered corporation tax. With effect from 1 April 2017 the rate of tax for all companies is 19%.

By contrast, money paid out by means of a salary or bonus attracts a corporation tax deduction. Consequently, money paid out as a salary or bonus does not suffer a corporation tax hit. However, payments made in this way attract a Class 1 NIC liability where the secondary threshold (employer contributions) and/or the primary threshold (employee contributions) is breached. Currently these are at the same level. PAYE must be applied as the salary or bonus is liable to income tax. However, paying a salary up to the secondary threshold means that the salary can be paid free of NIC, income tax (as the salary is within the personal allowance) and corporation tax (as salary payments are deductible for corporation tax purposes).

The options are therefore to pay corporation tax (and possibly income tax depending on the extent of the dividend) and extract profits by way of a dividend or to save corporation tax and instead pay income tax and NIC and extract profits by way of a salary or bonus. Which is the most tax-efficient solution will depend on the relative rates of corporation tax, income tax and NIC.

However, it should be noted that dividends must be paid in relation to the share holdings and thus lack the flexibility inherent in salary and bonus payments to pay different amounts to different individuals. However, this can be overcome by having a different class of share for each shareholder, allowing different dividends to be declared for each class of shares. It should be recognised that HMRC regard so-called "alphabet" shares as potentially manipulating the rates of tax suffered by the taxpayers.

Where profits are extracted by way of dividends, it is important to ensure that these are properly declared in accordance with *Companies Acts* requirements. Failure to do so paves the way for HMRC to contest that the payments are not dividends at all, but remuneration, and to apply tax and NIC accordingly.

It is worth considering the effective rates of tax,

Dividend versus salary: numerical illustrations

In deciding whether it is better to pay a salary or a bonus, there is no substitute for crunching the numbers. This needs to be considered both from the perspective of the recipient taxpayer and the company.

The examples in the slides illustrate the comparative positions for different levels of tax. It should be remembered that the goal is to maximise the amount of the profits that the director/shareholders and family company can retain.

4. £3,000 Employer NI Allowance

Previously, when extracting profit from an owner managed company, salary would have been withdrawn at a level guaranteeing that no employee or employer national insurance was payable (2018/19 - £8,424; 2017/18 - £8,164). Gross dividends would have been extracted to ensure that taxable income was just below the higher rate threshold (2018/19 - £46,350; 2017/18 - £45,000) and so no higher rate tax was payable. Remember that at this level clients are still protecting their entitlement to future state pension and benefits. You should remember that these are the limits that apply in the UK other than in Scotland. Additionally Scotland will have different bands of tax following the Scottish Budget on 14 December 2017.

However, adopting this low salary, high dividend strategy may mean that the small owner-managed business wastes the £3,000 employer national insurance allowance that now exists. By increasing the salary withdrawal to equal the personal allowance, a small amount of employee national insurance becomes payable but any employer national insurance is covered by the £3,000 employer national insurance allowance. Is this a beneficial strategy?

Increasing salary

Although the limits for the personal allowance and the higher rate threshold are known for 2018/19 this example uses the data for 2017/18. If we take a salary equal to the personal allowance of £11,500 instead of the usual £8,164, taxable income will consist of the £11,500 salary plus gross dividends of £33,500 totalling £45,000. No higher rate income tax is due.

Employees' NIC on the £11,500 salary will total £400 but no employers NI needs to be paid due to the £3,000 Employment Allowance.

This route incurs an additional £400 cost but saves corporation tax of £634 ((11500 – 8164) x 19%).

Comparison

The overall tax and NIC savings is £234. This is a small saving but worth having for small businesses and could be doubled where both husband and wife work in the company, assuming that the higher salary is justified for both parties. Note that this route also allows for higher pension contributions if that is of interest to the client.

Note that the employment allowance is not available, from 6 April 2016, to companies whose only paid employee is the sole director.

5. Transferable married couples allowance

From 6 April 2015 where one spouse or civil partner is not using their personal allowance they can transfer up to 10% of the allowance provided that neither party is a high rate taxpayer. So in 2017/18 this is worth £230, a small amount but still a saving that is worth having.

If a basic rate spouse is employed outside of the owner managed company, then paying the lower salary of £8,164 means that some of the unused personal allowance can be transferred to the their spouse. This negates the benefit of increasing the salary to £11,500 when you have a basic rate spouse who could utilise the transferred allowance.

In deciding whether to take a salary of £8,164 or £11,500 clearly it is important to consider the employment and tax position of both parties.

6. National minimum wage considerations

The national minimum wage (NMW) legislation seeks to ensure all workers receive a minimum wage level. The NMW rates applying from **1 April 2017 to 31 March 2018** are as follows:

Main rate: workers aged 25 and over	£7.50 an hour
Main rate: workers aged 21 to 24	£7.05 an hour
Workers aged 18 to 20 and workers aged 21 years and above, starting a new job with a new employer and doing accredited training (a course approved by the UK Government to obtain a vocational qualification)	£5.60 an hour
Workers aged under 18 but above compulsory school leaving age	£4.05 an hour
An apprentice rate for apprentices under 19 or, 19 and over in the first year of apprenticeship	£3.50 per hour

The NMW rates applying from **1 April 2018** on are as follows:

Main rate: workers aged 25 and over	£7.83 an hour
Main rate: workers aged 21 to 24	£7.38 an hour
Workers aged 18 to 20 and workers aged 21 years and above, starting a new job with a new employer and doing accredited training (a course approved by the UK Government to obtain a vocational qualification)	£5.90 an hour
Workers aged under 18 but above compulsory school leaving age	£4.20 an hour
An apprentice rate for apprentices under 19 or, 19 and over in	£3.70 per hour

the first year of apprenticeship

Adhering to NMW legislation is not a problem in relation to a shareholder director, as the legislation only applies to workers with a contract of employment. A director is classed as an office holder, regardless of how he or she is paid. Therefore the NMW legislation does not apply to directors unless they also have an employment contract, and it is therefore possible to pay them a small salary, or indeed no salary, and extract profits by way of a dividend without falling foul of NMW legislation.

However, where other family members who are not directors work for the company, the NMW legislation applies and such workers must be paid at or above the NMW. This may impact on a policy whereby the majority of profits are extracted by way of dividends.

7. Employing family members

Where other family members have unused personal allowances, consideration may be given to employing them so as to mop up their personal allowance. This can extend to employing children so as to use their personal allowances.

However, care must be taken here to ensure that the children are actually being paid to do a job. HMRC do not look favourably on arrangements that are essentially the payment of pocket money by the company. The amounts paid to the children should be reasonable in relation to the work done and should also take account of the relevant legislation on employing children. Depending on the age of the child, the national minimum wage may also need to be taken into account.