ACTIVE PRACTICE UPDATES

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1-2-1 TaxAccountants ICAEW CHARTERED ACCOUNTANTS

Salary or dividend?

What combination of salary and dividend should you take in 2017/18?

As the owner and director of your own company, you can choose how and when to extract funds from your company. As almost all the funds you take out will create a tax charge in your hands, you may want to leave a proportion of the money in the company until you really need it.

The tax charge you pay will depend on how your payment is categorised, such as salary, dividend, interest, rent or a loan. This article looks at the tax differences between extracting funds as a salary or a dividend.

For your company to pay you interest or rent, you must provide it with a sum of money or a property to use. Taking a loan from your company can be tax-efficient, but only when the loan is outstanding for a relatively short period of time.

Discuss your various loan options with us.

Salary

If you take all of your income as a salary it will be taxed under PAYE, so you will pay the tax due on a monthly basis.

The way in which tax and national insurance contributions (NICs) are calculated on slices of your income is as follows:

Annual slice of income	Tax rate	NICs rate	Total effective rate
Up to £5,876	nil	nil	nil
£5,876 – £8,164	nil	0%	0%
£8,165 – £11,500	nil	12%	12%
£11,501 – £45,000*	20%	12%	32%
£45,001* – £150,000	40%	2%	42%
More than £150,000	45%	2%	47%

*For Scottish resident taxpayers this threshold is £43,000.

Your personal tax allowance (£11,500 in 2017/18) is withdrawn by £1 for every £2 of your income which exceeds £100,000, so your effective tax rate on a salary between £100,000 and £123,000 is 60% plus 2% NICs.

The nil-rate in the table above indicates that no tax or NICs is paid. The 0% rate shows you are treated as if you had paid NICs on your earnings, so you get an national insurance credit that helps you build up your entitlement to the state pension. You need at least 10 qualifying years of NICs to receive any state pension.

Your company will have to operate a PAYE scheme and report the salary paid to you and any other staff every month or as often as you and the staff are paid. If your company makes a loss it can still pay you a salary, as long as the salary is a reasonable reflection of the work you do for the company.

Employer national insurance contributions

Your company must pay class 1 NICs at 13.8% on all of your salary which exceeds £8,164 per year.

Where your company employs another individual during the same tax year in which it pays you, it should qualify for the employment allowance (worth up to £3,000) to set against its class 1 NICs liability.

Companies that employ only the director, and those which operate in the public sector, don't qualify for the employment allowance.

Minimum salary

If you take a salary of between £5,876 and £8,164, it will attract no NICs as that amount is within the zero band for NICs. That salary is also covered by your personal allowance of £11,500, so no income tax is due either.

Salary or dividend?

Any further funds you need can be extracted from the company as dividends. You pay no tax on the first £5,000 of dividends you receive during a year as this is covered by the annual dividend allowance.

Dividend

If you take all of your funds from the company as dividends you will pay tax at these rates on the following slices of income:

Annual slice of income	Tax rate
Up to £11,500	nil
£11,501 – £16,500	0%
£16,501 – £45,000	7.5%
£45,001 – £150,000	32.5%
More than £150,000	38.1%

Comparing the tax cost of a dividend to a salary is not straightforward as the company must make a profit, and set aside money to pay tax on that profit, before it can pay a dividend (see example).

The company must have the available profits to pay out as a dividend, taking into account all of its commitments to pay taxes and other creditors. The company directors should record their decision to pay a dividend and issue dividend vouchers to the shareholders.

You are responsible for reporting the dividends you receive on your personal tax return. The tax due will be payable with your self-assessment by 31 January after the end of the tax year. However, HMRC may adjust your PAYE code to collect an estimated amount of tax due on your dividends during the tax year.

We can assist with drafting dividend documentation.

Example

Jack has paid himself a minimum salary of £8,164 (£680 per month). This ensures he has maintained his entitlement to the state pension for that year. Jack has a further £50,000 of untaxed profits in his company to pay out as a dividend or as a salary. He wants to maximise his net income.

Take as a salary

Corporation tax (CT) calculation		Tax and NICs paid
Profits	£50,000	
Employer's class 1 NICs	(£6,063)	
Salary payment	(£43,937)	
Taxable profits for the company	nil	nil
NICs calculation		
Jack's gross salary	£43,937	
Employee's NICs at 12% on	£36,836	£4,420.32
Employee's NICs at 2% on	£7,101	£142.02
Tax calculation		
Gross salary	£43,937	
Unused personal allowance (£11,500 – £8,164): taxed at 0%	£3,336	nil
Tax at 20%	£33,500	£6,700
Tax at 40%	£7,101	£2,840.40
Total tax and NICs payable		£14,102.74

After paying tax and NICs of £14,102.74, Jack will take home £37,998.26 including the £8,164 he paid himself as salary. The company will also pay class 1 NICs of £6,063.

Take as dividend

CT calculation		Tax and NICs paid
Profits	£50,000	
Corporation tax at 19%	£9,500	
Dividend paid	£40,500	
Income tax calculation		
Unused personal allowance (£11,500 – £8,164): taxed at 0%	£3,336	nil
Dividend allowance taxed at 0%	£5,000	nil
Taxed at 7.5%	£28,500	£2,137.50
Taxed at 32.5%	£3,664	£1,190.80
Total tax payable		£3,328.30

If Jack extracts all the available profits from his company as a dividend, after paying tax of £3,328.30, he will take home £45,335.70. The company will also pay CT of £9,500.

By taking a dividend instead of a salary, Jack will take home an additional £7,337.44 (£37,171.70 – £29,834.26).

Other considerations

Dividends are not 'pensionable earnings', so that income can't be used as the basis for making a personal pension contribution. However, if you control your own company it is more tax-efficient for the company to make an employer's pension contribution into your pension scheme.

The company's contribution is tax deductible and no employer's class 1 NICs are due. If the total pension contributions made in the tax year by you, and your employer, don't exceed your pension allowance (£40,000 in 2017/18), you won't pay tax on the contribution.

Dividends must be paid at the same rate for each share of the same class. If you own all the shares in your company, this is not an issue. However, where there are several shareholders who all hold the same type of shares, they must all receive a dividend at the same rate. A solution is for the company to issue shares of different classes to different shareholders.