Article for New Model Adviser

Q and A Tax

The Dividends vs Salary Equation

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Ben Dawson was waiting for Mark Best, one of his first clients after he became an IFA nearly 10 years ago to arrive for a meeting. Just over two years ago, Ben decided to transform the way he worked by setting up a fee-based practise, specialising in the small corporate market. Mark was one of the clients who opted to deal with Ben on his "Lite" tariff, paying for Ben's advice on a time spent basis, and this would be their first meeting since the transition.

Ben remembered that when they last met, Mark was deciding whether to set up on his own as a freelance garden designer. They'd got on well since they first met and Ben was looking forward to renewing their acquaintance.

After a knock on the door, Sally, Ben's office administrator, showed Mark in. He looked just as Ben remembered.

After reminiscing about old times and catching up on what had happened since they had last met, Mark explained why he had asked for the meeting. He had set up the limited company almost a year ago and was approaching his year end. The first year's trading had been encouraging and it looked as though the company was on line to make good profits this year, from which Mark wanted to take around £50,000 out of the company without paying more taxes than necessary. He had also been drawing a salary of £12,000 p.a.

"So, please can you explain to me the differences between taking money out of the company as salary, bonus or dividends?" asked Mark

"Well," Ben replied, "it depends on several different factors, including the rate of corporation tax that your company pays and your earnings as an employee. As these change over time, then the balance of which may be most tax effective may also change. There are also some other factors that you need to take into account that I can go through with you."

“So, firstly, let’s have a look at the situation if you used the £50,000 to pay dividends. If your company pays corporation tax on profits at the small companies’ rate of 20%....”

“But I thought I paid corporation tax at 19%, and wasn’t this also reduced in the Budget?” asked Mark.

“Unfortunately not”, Ben replied, “the main corporation tax rate reduces from 30% to 28% on the 1st April 2008, but the small companies rate was increased from 19% to 20% on 1 April this year, and further 1% increases over the following two years to 22% are in the pipeline. The Government stated that it is concerned that the sorts of strategies that we are discussing now are being used to achieve a reduction in personal tax and national insurance liabilities. By increasing the small companies rate, they think that it will encourage small businesses to reinvest profits for growth.”

“But that doesn’t really help my business and thousands of other small companies like mine, does it? To me, it really looks more like the small businessman being squeezed by the taxman,” said Mark. “Anyway, sorry for interrupting.”

“No problem” replied Ben, “I am in a similar situation, so understand your frustration. Now, as I was saying, if we look at using £50,000 to pay dividends, and let’s assume this is taxed at 20% so after your corporation tax liability of £10,000, £40,000 is left for the company to distribute as dividends. The £40,000 then has to be split between all of the shareholders in proportion to their shareholdings.”

“That’s not a problem, I own all of the shares at the moment” said Mark

“Good, that makes it easier to explain” continued Ben. “So, you receive a dividend of £40,000. This has to be grossed-up for income tax purposes to £44,444 and this is then added to your other taxable income to determine the tax payable on the dividend. What other income do you expect to have this year, Mark?”

“Well, not a lot really. I did receive an inheritance about 18 months ago which is in the building society – it was this that helped me decide to go out on my own. I think I’ll receive about £2,200 interest this year as I have been withdrawing a bit of capital to tide me over.”

Ben did a quick calculation. “OK, Mark. Now, your tax calculations are really for your accountant, but, for the purposes of this, and to make the figures easy, let’s assume that your salary and the interest from the building society leave you with taxable income of £9,600 once we deduct your personal allowance.”

“This would mean that £25,000 of the dividend you receive would fall into the basic rate tax band which means it doesn’t attract any further tax liability, with the balance taxed at 32.5%, giving an additional tax liability of around £4,375. So, in effect, you end up with an extra £35,625 in your hand – don’t worry about how I calculated this, I’ll confirm the figures in writing, and also show some other scenarios!”

“Now, let’s look at the situation if you took a bonus instead; because of your shareholding in the company, this would be treated in the same way as if you received it all as salary.”

“As salary and bonus payments are tax-deductible, the company has £50,000 available to fund the bonus, but has to pay Class I employer national insurance contributions of 12.8%, so the amount of bonus it can pay you is £44,326 with £5,674 to HMRC for the national insurance contributions.

The tax calculation is a little more complicated, but the additional income tax liability as a result of the bonus payment would be £13,286….”

“So that’s going to leave me with about £31,000 in my hand. It’s worse than the dividend, isn’t it?” said Mark.

“Yes, but I’m afraid it doesn’t stop there. As this is effectively treated as salary in your case, you’re also liable to pay Class I national insurance contributions as an employee. This works out at around an additional £2,727, so you actually end up with an additional £28,313 in your hand.”

Mark looked horrified “So the taxman ends up with nearly half of the profits I earned in my company! The dividend definitely looks the better route.”

“If only it were that simple,” Ben answered. “You also need to look at a couple of other things. Firstly, if you wanted to apply for credit or raise a loan or mortgage, most lenders would base your ability to repay on your salary and ignore dividend income, so with a salary of £12,000 it is unlikely that you’d be able to borrow much. Also, if you are making, or thinking of making large pension contributions, then your ability to receive tax relief on the contributions may be limited, although it is possible for the company to make the contribution on your behalf. If these are not a problem, we could also look at reducing your salary to allow you to receive a higher dividend, but that could have a knock on effect on future state benefits, such as the Second State Pension.”

“Another option would be, perhaps, to use a mixture of dividends, salary and bonuses and pension contributions made by the company. Had you made personal pension contributions this year, then the figures we discussed would have changed. Perhaps the best thing is for me to set out the figures for each so that you can study them in detail and then we could meet again in a week or so. How does that sound?”

“I think that’s sensible, there are still four or five weeks before my year end. It was good to see you again, Ben, and I’m looking forward to our next meeting.”

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Mark's current tax situation

Salary			£12,000
Gross building society interest (assume)			£ 2,825
Gross income			£14,825
Less personal allowance			£ 5,225
Taxable income			£ 9,600
Savings income	£ 2,825		
Non-savings income	£ 6,775		
Income tax			
Non-savings income	0 - £2,230	@10%	£ 223
	£2,230 - £6,775	@22%	£ 1,000
Savings income	£2,825	@20%	£ 565
Total income tax liability			£ 1,788
Mark's Class I NICs			£ 748
Total tax liability	£1,788+£748		£ 2,536

Note 1. Tax rates based on 2007-08.

Dividends

Pre-tax profits available for distribution	£50,000
Corporation tax @ 20%	£10,000
Net amount available to distribute	£40,000

Note 2. Dividend is not tax deductible, so corporation tax liability is (assume) 20%

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Mark's tax situation after receiving dividend

Salary			£12,000
Gross building society interest (assume)			£ 2,825
Grossed-up dividend £40,000/0.9			£44,444
Gross income			£59,269
Less personal allowance			£ 5,225
Taxable income			£54,044
Savings income	£ 2,825		
Dividends	£44,444		
Non-savings income	£ 6,775		
Income tax			
Non-savings income	0 - £2,230	@10%	£ 223
	£2,230 - £6,775	@22%	£ 1,000
Savings income	£2,825	@20%	£ 565
Dividend	£25,000	@10%	£ 2,500
	£19,444	@32.5%	£ 6,319
Total income tax liability			£10,607
Mark's Class I NICs			£ 748
Total tax liability	£10,607+£748		£11,355
Difference in tax	£11,355-£2,536		£ 8,819
Dividend received after tax	£44,444-£8,819		£35,625

Note 3. Assumes that Mark has not made any personal pension contributions during the tax year 2007-08.

<u>Salary/ Bonus</u>

Pre-tax profits available for distribution	£50,000
Employer's Class I NIC	£ 5,674
Net amount available to distribute as bonus/ salary	£44,326

Note 4. Bonus, salary and employer's NICs are all deductible for corporation tax purposes

Mark's tax situation after receiving bonus

Salary			£12,000
Bonus			£44,326
Gross building society interest (assume)			£ 2,825
Gross income			£59,151
Less personal allowance			£ 5,225
Taxable income			£53,926
Savings income	£ 2,825		
Non-savings income	£51,101		
Income tax			
Non-savings income	0 - £2,230	@10%	£ 223
	£2,230-£34,600	@22%	£ 7,121
	£16,501	@40%	£ 6,600
Savings income	£2,825	@40%	£ 1,130
Total income tax liability			£15,074
Mark's Class I NICs			£ 3,475
Total tax liability	£15,074+£3,475		£18,549
Difference in tax	£18,549-£2,536		£16,013
Bonus received after tax	£44,326-£16,013		£28,313

Note 5. Remuneration received by directors is normally assessed for NICs as if it arose on a yearly basis