Article for New Model Adviser

Q and A Tax

The Dividends vs Salary Equation (continued)

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At their last meeting, Ben Dawson explained the intricacies of the dividend vs salary/ bonus equation to his client, Mark Best.

Mark has now come back for a follow-up meeting with Ben a few days before his company year end.

“So, Mark”, starts Ben, “how did you get on with the figures that I sent you after our last meeting?”

Mark laughs, “It took a while, but I think I got there in the end, although I really don’t know how punters like me are meant to understand tax! Mind you, I guess it must be getting easier, each Budget the Chancellor talks about how he is simplifying the tax system.”

“If only….” replies Ben.

“Anyway”, continues Mark, “I have thought it through, and taken account of your warnings about the effect that dividends may have on my ability to borrow money and make pension contributions, but think that the dividend route offers me some significant benefits as I will still end up with over £7,300 more in my hands than if I took bonuses. It does not seem right, though, that I am paying tax at 32.5% on some of the dividend after the company paid 20% corporation tax as well – by the time I have spent it and paid VAT and other duties, I’ll be lucky to end up with anything! Is there anything else I can do to reduce the tax bill?”

“Well, there are a couple of other things that you could consider”; says Ben, “ if you decided to make pension contributions, you would receive some tax relief on the contributions and potentially pay less tax on part of the dividends, but it would be a trade off between the amount that you receive in your hands today and starting to fund for your income in retirement.”

“ I understand that, but I was thinking that now the company has got off the ground (no pun intended by a garden designer), then maybe I should start thinking about pensions – how would pension contributions affect my tax bill then, Ben?”

"The first thing to look at is who will make the contributions – you or your company. If the company pays, then the contributions can be set against the corporation tax liability and are also not liable for national insurance. If you pay the contributions, there are the tax benefits I have just mentioned. So, let's just recap on the situations we looked at during our last meeting and then we can have a look to see how pension contributions could affect these." Ben removes a copy of the figures prepared after the last meeting from the folder in front of him and picks up his calculator.

"You feel that there is around £50,000 that you want to remove from the company. If you used this to pay dividends, the company would pay corporation tax and we estimated the amount that you would receive after tax at £35,625. If you took the money as a bonus then both you and the company would pay national insurance and after tax you would end up with £28,313. Now you obviously want to receive most of this amount yourself, whichever route you take, but how much do you think you could comfortably afford to put towards a pension, Mark?"

"I don't really know – business looks good at the moment, and I expect higher profits next year. I have also got used to living on quite a lot less than the amount you showed me that I would receive last time, partly by not paying into pensions and things, so I guess I have some catching up to do! Why don't you assume, say, £10,000 going towards pensions and if that doesn't leave me much, we could always reduce it."

"OK." Ben starts to amend the figures on the sheet "Don't worry Mark, I'll send you a tidied-up version of what we end up with in the next couple of days, but let's work through this together. Let's look first at the dividend situation – and assume that you pay the pension contribution yourself. As you receive tax relief at source of 22% on your personal contributions, a £10,000 contribution only costs you £7,800. As the dividend you have received has made you a higher rate taxpayer, you are also entitled to some higher rate tax relief – this is given by "stretching" your basic rate tax band by the amount of the gross pension contribution, so £10,000 of the dividend that was previously have been taxed at 32.5% is now taxed at 10%, saving you £2,250 in tax, so, the net amount you receive in your hand is £30,075. In other words, the £10,000 pension contribution has cost you £5,550."

"So I've got 44.5% tax relief, how is that possible?" asks Mark.

"It's the combination of the 22% tax relief on the pension contribution and the 22.5% tax saving on the dividend by stretching your basic rate band."

"Wow, sounds painful", laughs Mark, "but I like the figures!"

"Good. Now let's see how it would look if the company paid the pension contribution and you reduced the dividend amount", Ben continues, "The remaining £40,000 after the pension contribution will be liable to corporation tax of £8,000, leaving £32,000 to distribute. This grosses up to £35,555 (remember the tax credit?) so your tax calculation shows a lower dividend amount by £8,889 saving tax of £2,889 and leaving you with a net dividend payment of £29,625 in your hand, or £450 less than if you had made the pension contribution."

"So, not so good then", says Mark, "and if we look at the bonus route?"

"The principles are the same, but maybe a bit more complicated. Now if you make the pension contribution, you need to pay £7,800 and your tax bill reduces by £1,800 by stretching your basic rate band, giving a net bonus in your hand, after the pension contribution and national insurance of £22,313."

"And, if the company pays the pension contribution, it gets more complicated as the company's national insurance liability reduces if only £40,000 is available, allowing £35,461 to be paid as the bonus. Plugging this into the tax calculation gives you a net bonus, after tax and national insurance of £23,083."

"Well, that was impressive", Mark says, "but you could have stopped after the first calculation as that looks the best one for me, unless you have anything else to suggest?......"

<u>Mark's current tax situation</u>

Salary			£12,000
Gross building society interest (assume)			<u>£ 2,825</u>
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%	<u>£ 565</u>
Total income tax liability			£ 1,788
Mark's Class I NICs			<u>£ 748</u>
Total tax liability	£1,788+£748		£ 2,536

Note 1. Tax rates based on 2007-08.

Dividends if Mark pays pension contribution

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%

Mark's tax situation after receiving dividend if Mark pays pension contribution

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	£35,000	@10%	£ 3,500
	£9,444	@32.5%	£ 3,069
Total income tax liability			£ 8,357
Mark's Class I NICs			£ 748
Total tax liability	£8,537+£748		£ 9,105
Difference in tax	£9,105-£2,536		£ 6,569
Dividend received after tax	£44,444-£6,569		£37,875
Less net pension contribution			£30,075

Dividends if company pays pension contribution

Pre-tax profits available	£50,000
Company pension contribution	£10,000
Available for distribution	£40,000
Corporation tax @ 20%	£ 8,000
Net amount available to distribute	£32,000

Note 3. Dividend is not tax deductible, so corporation tax liability is (assume) 20%

Mark's tax situation after receiving dividend if company pays pension contribution

Salary			£12,000
Gross building society interest (assume)			£ 2,825
Grossed-up dividend £32,000/0.9			£35,555
Gross income			£50,380
Less personal allowance			£ 5,225
Taxable income			£45,155
Savings income	£ 2,825		
Dividends	£35,555		
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
	£10,555	@32.5%	£ 3,430
Total income tax liability			£ 7,718
Mark's Class I NICs			£ 748
Total tax liability	£7,718+£748		£ 8,466
Difference in tax	£8,466-£2,536		£ 5,930
Dividend received after tax	£35,555-£5,930		£29,625

Note 4. Assumes that Mark has not made any personal pension contributions during the tax year 2007-08.

Salary/ Bonus if Mark pays pension contribution

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

Mark's tax situation after receiving bonus if Mark pays pension contribution

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-£44,600	@22%	£ 9,321
	£6,501	@40%	£ 2,600
Savings income	£2,825	@40%	£ 1,130
Total income tax liability			£13,274
Mark's Class I NICs			£ 3,475
Total tax liability	£13,274+£3,475		£16,749
Difference in tax	£16,749-£2,536		£14,213
Bonus received after tax	£44,326-£14,213		£30,113
Less net pension contribution			£22,313

Note 6. Remuneration received by directors is normally assessed for NICs as if it arose on a yearly basis

Salary/ Bonus if company pays pension contribution

Pre-tax profits available	£50,000
Company pension contribution	£10,000
Available for distribution	£40,000
Employer's Class I NIC	£ 4,539
Net amount available to distribute as bonus/ salary	£35,461

Note 7. Bonus, salary and employer's NICs are all deductible for corporation tax purposes

Mark's tax situation after receiving bonus if company pays pension contribution

Salary			£12,000
Bonus			£35,461
Gross building society interest (assume)			£ 2,825
Gross income			£50,286
Less personal allowance			£ 5,225
Taxable income			£45,061
Savings income	£ 2,825		
Non-savings income	£42,236		
Income tax			
Non-savings income	0 - £2,230	@10%	£ 223
	£2,230-£34,600	@22%	£ 7,121
	£7,636	@40%	£ 3,054
Savings income	£2,825	@40%	£ 1,130
Total income tax liability			£11,528
Mark's Class I NICs			£ 3,386
Total tax liability	£11,528+£3,386		£14,914
Difference in tax	£14,914-£2,536		£12,378
Bonus received after tax	£35,461-£12,378		£23,083

Note 8. Remuneration received by directors is normally assessed for NICs as if it arose on a yearly basis.