Profit Extraction - Dividends vs Salaries & Bonuses

BUSINESS TAX GUIDE

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OVERVIEW

In many small companies the owners are also the directors and this presents opportunities for deciding how profits should be withdrawn from the company.

Traditionally, small companies pay salaries to the directors and ignore their role as shareholders. Shareholders in publicly traded vehicles are making an investment and expect a return on that via dividends and capital growth and investors in small companies should be no different.

Owner managers do however have the flexibility to determine how best to structure their overall return from their investment and effort involved in running the business. Assuming there is excess profit within the business, which is not otherwise required for reinvestment, this guide highlights the main considerations when choosing between dividends and bonuses - the two most popular routes of extracting profits.

When choosing between salary/bonus and dividends the main considerations are:

Corporation Tax

Corporation Tax is charged on the profits of the business after accounting for salaries and bonuses. As the payment of salaries and bonuses reduces profits, any corporation tax liability will be reduced likewise. The deductibility of these is not usually in question though it is important to note that directors' bonuses accrued at the end of an accounting period need to be paid through payroll before the usual date for settlement of the corporation tax liability for that year (i.e. they should be paid within nine months of the end of the accounting period). Dividends are not deductible for corporation tax purposes.

Corporation tax is currently charged at 20% which is set to fall to 19% from April 2017 and again to 17% in April 2020.

Income Tax

UK tax resident shareholders are liable to income tax on all profits withdrawn from a company by way of divided.

For a basic rate taxpayer, any dividend income earned within this threshold will be taxed at an effective rate of 7.5% and at 32.5% and 38.1% for higher rate and additional rate taxpayers respectively. There is also, since April 2016, a new dividend tax allowance of £5,000 which will operate as a 0% tax rate, meaning the income will still count towards an individual's limits.

Conversely, bonuses are taxed as 'earned income' just as salaries are and must be paid via payroll and subject to full income tax rates of 20%, 40% and 45% for basic, higher and additional rate taxpayers respectively.

National Insurance Contributions

National Insurance Contributions ('NICs') are only payable on salaries and bonuses i.e. dividends are exempt. There are two elements - employee contributions and employer contributions. Employees currently pay National Insurance contributions at 12% on earnings broadly within the basic rate tax band (this is in the process of being fully aligned between the income tax and national insurance tax codes). Earnings in excess of this are taxed for employees' NIC purposes at 2%.

Employers currently pay National Insurance contributions at 13.8% on all salaries and bonuses above a modest annual threshold (per employee). In the case of bonuses, this will almost inevitably mean that the cost of the bonus to the company will increase by 13.8% to reflect the associated Employers' NIC liability.

Employment Allowance

The NICs Employment Allowance was introduced in April 2014 to reduce the Employer's NIC bill by up to £2,000 per year, increased to £3,000 per year from April 2016. Also from April 2016, the allowance will not be available where the director is the only employee paid earnings above the Secondary Threshold for class 1 NICs (currently £156 per week).

Company Law

Whilst dividends can only be paid out of profits for the year (or any undistributed profits from previous years) salaries can be paid when a company is making a loss.

Other Shareholders

Salaries can be allocated to different directors at different rates. A shareholder is entitled to a dividend in proportion to the number of shares held. This means that non-working shareholders would participate in any dividend declared even if it is felt by management that those shareholders have not economically contributed to the underlying profits.

This lack of flexibility can be countered by creating different classes of share with different entitlements to dividends, though care and advice must be taken in this regard.

Cashflow

Tax deadlines vary depending on the tax in question:

- PAYE – Monthly
- National Insurance – Monthly
- Corporation Tax – Nine months and one day after the company's year-end unless the company is required to make payments under the quarterly instalments regime (where its profits are deemed 'large' for corporation tax purposes)
- Income Tax on Dividends - 31 January after the end of the tax year in which the dividend is paid (payments on account may be required where there is a regular pattern of dividends).

Pensions

An alternative to bonus and dividend payments is for the company to make contributions to the pension plans of director/shareholders. Such payments are tax deductible for corporation tax purposes though restrictions may apply to the contributions each individual will be entitled to make dependent upon personal circumstances. Further consideration of this aspect is outside the scope of this guide.

How can Rawlinson & Hunter help?

It is clear that many factors need to be considered when deciding whether director/shareholders should be paid by dividend, salary/bonus, employer pension contributions or other mechanisms. Subject to the impact of IR35 (intermediaries legislation) a mixture of all of these is usually the best course of action. Rawlinson & Hunter can provide tailored advice based on current or proposed structures.

If you are interested in further information in this regard, please contact the Rawlinson & Hunter partner who normally acts for you. Where you are not one of our regular clients, please contact Craig Davies or Andrew Shilling, who would be delighted to discuss this with you in more detail.

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