

Company Bonus or Dividend?

In many small companies, the owners are also the directors, and this gives considerable scope for deciding how profits should be taken out of the company.

Traditionally, small companies pay salaries to the directors and tend to ignore their second role as shareholders, which entitles them to receive dividends.

Where profits are retained within a company, the situation is governed by the corporation tax rules, but when you draw profit out, income tax rules take over, and national insurance rears its ugly head.

The main considerations for choosing between salary and dividends are:

Corporation tax

This is charged on the profits of the business after taking into account all salaries. Paying a salary reduces profits and hence reduces the corporation tax bill.

A dividend payment does not reduce the taxable profit.

Income tax

As mentioned above, income tax is chargeable on all profits withdrawn from a company. On salary, it is collected through the PAYE system. A dividend carries with it a 10% tax credit, and for a basic rate taxpayer there is no further tax to be paid. A higher rate taxpayer will have to pay additional income tax equivalent to 25% of the dividend paid. This increases to 36.1% for those with taxable income over £150,000.

National insurance contributions

National insurance contributions are payable on salaries, but not on dividends. There are two elements - employee contributions and employer contributions. Employees pay 12% (2011-12) on earnings between the employee earnings threshold and the upper earnings limit, and 2% on earnings above this without any upper limit. Employers pay 13.8% (2011-12) on all salaries above £7,072 p.a. without any upper limit.

Company law

Salaries can be paid even when a company is making a loss. Dividends can be paid only out of profits for the year, or any undistributed profits from previous years.

Other shareholders

Salaries can be allocated to different directors at any rate. 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.

This lack of flexibility can be countered by creating different classes of share with different dividend entitlements.

Cashflow

PAYE and national insurance are payable monthly; corporation tax is payable nine months and one day after the company's year end. Dividend upper and additional tax is payable on 31 January after the end of the tax year in which the dividend is paid (payments on account may be required).

Pensions

Payments of additional salaries can enhance the contributions that can be paid to pension schemes. For certain types of scheme, benefits can be based on the pay for the best three out of the last ten years before retirement, so planning for high salaries can be used to advantage.

EXAMPLE

The chart on the following page illustrates the potential advantage of using dividends rather than a salary bonus to extract profits of £10,000 from a small company. The example assumes that the directors are already being paid salaries that take them into the higher or additional rate of income tax. As this transition coincides with the national insurance normal upper limit, employee's contributions at 2% and employers' contributions at 13.8% will be payable.

| | 40% Taxpayer | | 50% Taxpayer | |
|-------------------------------|--------------|---------------|--------------|---------------|
| | Bonus £ | Dividend £ | Bonus £ | Dividend £ |
| Profit | 10,000 | 10,000 | 10,000 | 10,000 |
| Employers' national insurance | (1,213) | | (1,213) | |
| Salary available | <u>8,787</u> | | <u>8,787</u> | |
| Corporation tax | | (2,000) | | (2,000) |
| Dividend | | <u>8,000</u> | | <u>8,000</u> |
| Income tax @ 40%/50% | (3,515) | | (4,394) | |
| Additional income tax | | (2,000) | | (2,888) |
| Employee's national insurance | (176) | | (176) | |
| Net amount available | <u>5,096</u> | <u>6,000</u> | <u>4,217</u> | <u>5,112</u> |

This example shows an overall saving of £904 (40% taxpayer) or £895 (50% taxpayer) by paying a dividend.

It is clear that many factors must be considered when deciding whether directors should be paid by dividend or salary/bonus. In practice, a mixture of each is usually the best course, subject to the impact of 'IR35'.

Care and professional advice should be taken in all cases. An individual's and company's specific circumstances must be reviewed and the advice tailored to the particular needs.

Do call us if you would like further help or advice on this subject.