Dividends vs salaries and bonuses

All change for profit extraction from April 2016?

All limited company owner-managers should regularly review how best to structure their income – whether by salary, bonus or dividends. Changing tax rates, fluctuating incomes from year to year, and the year in which income is taken can all affect how much tax you pay and when you have to pay it.

Big changes to dividend rates announced in the summer 2015 Budget, which take effect from April 2016, mean that many companies must review their current strategy or at the very least understand how the changes will affect their shareholders.

Where do I begin?
It's important to appreciate that salaries, bonuses, benefits-in-kind and so on are expenses of the business and are deducted in calculating the corporate profits subject to taxation. On the other hand, dividends are a distribution of profit, so no deduction for them is allowed when working out your corporation tax liability.

A company that makes a profit and which decides to declare dividends will have a corporation tax liability to be taken into account when deciding the level of dividend to pay. Companies are only allowed to declare dividends that are covered by their distributable reserves. Broadly speaking, this means undistributed accumulated profits.

To establish the most tax efficient structure for your income, you need to take into account corporation tax, National Insurance Contributions (NIC) (for both the employer and employee) and income tax. Start with the company's profit and work through the options, in each case establishing the net after tax income for employee/shareholder. It can be useful to consider more than one tax year.

Salaries and bonuses
Payroll costs, such as salaries and bonuses, are generally liable to NICs. Employer contributions are 13.8% of an employee's gross salary in excess of the secondary threshold (£8,112 for 2015/16) without any upper limit. There are also contributions from employees, which are generally 12% of earnings between £8,060 and £42,385, and 2% on any excess.

If the whole of the profit liable to corporation tax is spent on bonuses and NICs, there will not be any corporation tax to pay. The corporate tax rate is currently 20%, while just five years ago the main rate of corporation tax was 28%.

Dividends
Up until 5 April 2016, dividends are treated as being received net of a 10% 'notional' tax credit – one-ninth of the actual dividend received. It's considered notional because it's not actually paid by the company declaring the dividend.

Gross dividends that fall within a taxpayer's 20% rate band are not subject to further taxation. Dividends that fall within the 40% higher rate band are taxed at 32.5% with a credit given for the notional tax, meaning that the higher rate tax is effectively 25% of the net dividend. Additional rate taxpayers (those paying at 45%) currently pay tax on the deemed gross dividend at 37.5%, resulting in an effective rate on the net dividend of 30.56%.

From 6 April 2016, the notional tax credit will be abolished and new tax rates will apply to the cash dividend: 7.5% for basic rate taxpayers, 32.5% for basic rate taxpayers and 38.1% for additional rate taxpayers. These rates apply to the net dividend with no credit for any notional tax (see Figure 1).

	Basic rate tax payer		Higher rate tax payer		Additional rate tax payer	
	2015/16	2016/17	2015/16	2016/17	2015/16	2016/17
	£	£	£	£	£	£
Cash dividend*	80	80	80	80	80	80
Notional tax credit	8.89	0	8.89	0	8.89	0
Gross dividend	88.89	80.00	88.89	80.00	88.89	80.00
Tax rate	10.00%	7.50%	32.50%	32.50%	37.50%	38.10%
Tax	8.89	6.00	28.89	26.00	33.33	30.48
Less: Tax credit	–8.89	0.00	–8.89	0.00	–8.89	0.00
Additional tax payable	0.00	6.00	20.00	26.00	24.44	30.48
Overall net to individual	**80.00**	**74.00**	**60.00**	**54.00**	**55.56**	**49.52**
Effective rate on cash dividend	0.00%	7.50%	25.00%	32.50%	30.56%	38.10%

*In excess of the £5,000 tax free dividend allowance

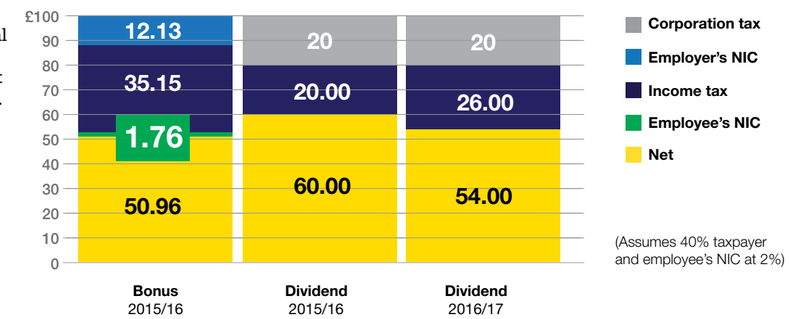
Figure 1: New dividend rates

Working out the best structure
While it's often useful to work through the detailed numbers that apply in your circumstances, in most cases, if salaries or bonuses are paid, the extra income tax when combined with the NICs liability (both employer and employee) is more than the corporation tax saving.

Figure 2 compares payment of £100 of corporate profits for 2015/16 by salary/bonus with payment by a dividend, and goes on to show the dividend position for 2016/17.
Although dividends are still often best, some would argue that by changing the tax treatment of dividends, the end result is similar to making private company dividends subject to NICs. This has been a favourite topic of many Budget speculators for a good ten years!

While dividends still look attractive the advantage may not be enough to determine the overall decision.

Figure 2: Comparative treatment of £100 of corporate profit



Consider the bigger picture
These new rules apply to all types of companies – not just to unquoted companies. To mitigate the impact on normal investors who receive dividends on typical share portfolios, dividend income of up to £5,000 will be exempt from the new dividend tax charge. On a generous 5% yield this equates to shares worth £100,000. If you only receive modest dividend income on your investments and your other income is subject to PAYE, then this change could mean that you won't have to file a tax return in future.

Net income is not the only factor to consider. For example, it can make sense for owners to pay themselves a salary so that the year counts for the purposes of the state pension (see Money Matters on the back page for details about forthcoming changes to the state pension). There are also complications around pension contributions and when the company uses a property owned by its shareholders.

Plan ahead
It's important to have a clear understanding of the impact of the new rules and to plan accordingly. It might be possible to pay interest to those who have lent a company money, for family member shareholders to receive dividends to take advantage of the 7.5% rate as opposed to 32.5%, or for dividends to be declared and paid before 6 April 2016. The overall impact could be significant and may require budgets and plans to be updated.

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