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## **Salary versus Dividends**

**How to Extract Company Profits and  
Reduce Your Tax Bill By Thousands**

**By Carl Bayley BSc ACA**

## Important Legal Notices

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TAX GUIDE – “Salary versus Dividends”

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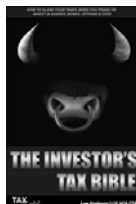
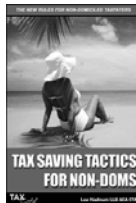
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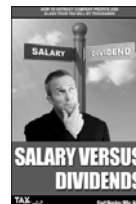
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## About the Author

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Carl Bayley is the author of a series of 'Plain English' tax guides designed specifically for the layman and the non-specialist. Carl's particular speciality is his ability to take the weird, complex and inexplicable world of taxation and set it out in the kind of clear, straightforward language that taxpayers themselves can understand. As he often says himself, "my job is to translate 'tax' into English".

Carl enjoys his role as a tax author, as he explains: "Writing these guides gives me the opportunity to use the skills and knowledge learned over almost twenty-five years in the tax profession for the benefit of a wider audience. The most satisfying part of my success as an author is the chance to give the average person the same standard of advice as the 'big guys' at a price which everyone can afford."

Carl takes the same approach when speaking on taxation, a role he frequently undertakes with great enthusiasm, including his highly acclaimed annual 'Budget Breakfast' for the Institute of Chartered Accountants.

In addition to being a recognised author and speaker on the subject, Carl has often spoken on taxation on radio and television, including the BBC's 'It's Your Money' programme and BBC Radio 2's Jeremy Vine Show.

Carl began his career as a Chartered Accountant in 1983 with one of the 'Big 4' accountancy firms. After qualifying as a double prize-winner, he immediately began specialising in taxation.

After honing his skills with several major international firms, Carl began the new millennium by launching his own tax and accounting practice, Bayley Miller Limited, through which he provides advice on a wide variety of taxation issues; especially tax planning for small and medium-sized businesses, property taxation and Inheritance Tax planning.

Carl is a member of the governing Council of the Institute of Chartered Accountants in England and Wales and a former Chairman of ICAEW Scotland. He has co-organised the annual Peebles Tax Conference for the last eight years.

When he isn't working, Carl takes on the equally taxing challenges of hill walking and writing poetry and fiction. Carl lives in Scotland with his partner Isabel and has four children.

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## Chapter 1

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# Introduction

### **1.1 WHY IS THE SALARY OR DIVIDEND QUESTION SO IMPORTANT?**

For many years, one of the most frequently asked questions in tax planning has been “Salary or Dividend?”

The question arises whenever the ‘director/shareholder’ (or ‘owner/manager’) of a small or medium-sized company wishes to extract funds from their business as tax efficiently as possible.

On the face of it, it may seem like a fairly simple question. Like so many apparently simple questions in the tax world, however, the number of factors which need to be taken into account render the answer quite complex.

In fact, the complexity of this issue is matched only by its importance, as thousands of pounds are often at stake.

Unlike most other people, director/shareholders are in the fortunate position of wearing two caps. On the one hand, they can reward their efforts as an employee with salary or a bonus; on the other they can reward their entrepreneurship with a dividend.

Furthermore, as we shall see later in this guide, salaries, bonuses and dividends are not always the only options and other methods for extracting company funds are often also available. In practice, there is far more to the ‘Salary versus Dividends’ question than salaries and dividends!

The good news is that, to a large extent, you can often decide how you would like any distribution of the company’s money to its owner to be classified.

Tax savings will be a prime consideration, but there are many other factors which may also influence your decision.

In recent years, the ‘Salary versus Dividends’ issue has taken on more importance than ever, owing to significant changes in the rates of both Corporation Tax and National Insurance.

Salaries and bonuses are subject to National Insurance, but are usually eligible for Corporation Tax relief. In other words, the company can usually deduct salaries and bonuses in arriving at its taxable profits.

Dividends are not subject to National Insurance, but must be paid out of the profits remaining *after* the company has paid its Corporation Tax bill.

The importance of Corporation Tax relief has fluctuated significantly in recent years with the abolition of the 0% starting rate in 2006 followed by increases to the small companies rate of Corporation Tax in 2007 and 2008. The new Coalition Government now proposes to reduce Corporation Tax rates once more, starting in April 2011, meaning that the whole company tax planning landscape will be undergoing yet more changes over the next few years.

Despite the change of Government, however, personal tax rates are set to remain high. The new 'super tax' rate of 50% on income over £150,000 is to be retained for the foreseeable future and the proposed National Insurance rate increases, initially announced by Alistair Darling, are to go ahead as planned on 6<sup>th</sup> April 2011.

Against this background of a seemingly ever-changing taxation regime, the 'Salary versus Dividends' question continues to be a vital part of tax planning for company owners.

In fact, what many business owners don't realise is that structuring company distributions carefully by making the optimum split between dividend, salary or bonus and any other payment options available can make an enormous difference to their net personal income.

In many cases, a company owner may obtain a significantly higher after-tax income than a regular employee earning a higher before-tax salary.

In this guide, we will examine the complex, but important, 'Salary versus Dividends' question in detail. We will deal with each of the important taxation factors which need to be considered in turn and then proceed to provide an overview of the possible answers.

We will include a look at some of the alternative ways to take money out of the company, such as interest, loans and non-cash payments. The practical uses of loans to directors, in particular, have increased immensely since unlimited loans from private companies were legalised in 2007.

In short, we will take a journey through all of the complexities involved in the question in order to arrive at a simple summary of the possible answers.

Having dealt with the 'Salary versus Dividend' issue, we will then progress to looking at another alternative use of company money – reinvestment for capital growth.

Despite the recent increase in the main rate of Capital Gains Tax to 28% (for higher rate taxpayers), the UK still has a very generous Capital Gains Tax regime for small company owners.

Most small company owners can now sell their company after just one year of trading and pay Capital Gains Tax at just 10% on up to £5m worth of capital growth!

In this sense, selling a company may be regarded as a means of converting taxable income (i.e. your future salary and business profits) into capital gains which are taxed at a considerably lower rate. With personal income now being taxed at marginal rates of up to 61% and capital gains taxed at just 10% in many cases, the potential savings are enormous.

Finally, we will look at some additional factors which should be considered before making the all-important 'Salary or Dividend' decision, and also a number of special cases where some recent developments in tax law will need to be addressed.

## **1.2 WHICH COMPANIES ARE AFFECTED?**

The 'Salary or Dividend' question is relevant to every company owner wishing to extract money from their business. In fact, we will even see some situations where additional salary or a dividend may itself be used as a tax planning tool, even when the director has no actual desire to remove funds from the company. Let's face it though; most company owners are going to have to take some money out of their company in most years – so why not do it tax efficiently?

The vast majority of the principles explored in this guide will be equally valid for trading companies or investment companies. Only the occasional foray into Capital Gains Tax or Inheritance Tax will give rise to any differences.

Most property investment companies, for example, will be subject to the same Corporation Tax rates as a trading company and their

directors will be taxed on salary, bonuses or dividends in just the same way as if these had been received from a trading company.

A few investment companies will, however, be classed as a 'Close Investment Holding Company'. This does lead to some important differences, which we will look at in Section 10.7.

### **1.3 MARGINAL RATES AND THE INEVITABLE TRADE-OFF**

What makes the 'Salary or Dividend' question so complicated is the inevitable trade-off between the tax payable by the director and the tax relief being obtained by the company.

As a company owner you are, of course, not only interested in your *personal* tax position but that of the *company* as well. Logically, therefore, your aim must be to minimise the *total* tax paid both personally and by the company.

When looking at either side of the personal/company tax equation, it is always essential to consider what we call the *marginal* tax rates rather than the *total* tax burdens. A marginal tax rate is the tax due on each *additional* amount of profit or income. For example, you may be a higher rate taxpayer, but that does not mean that you pay 40% Income Tax on all of your income. No, you only pay the 40% rate on each £1 of income above a certain level.

It is, however, the marginal tax rate which is relevant in calculating the tax that you will pay on any additions to your income.

So it is with companies. For example, the company's total tax bill might amount to 26% of its taxable profits. However, its marginal Corporation Tax rate might be 29.75%. In this case, it is the 29.75% rate which is relevant to our calculations.

The company's marginal tax rate is important because it can be thought of as the tax *saved* by each additional £100 of business expenditure – which includes salaries and bonuses. An additional £100 bonus paid to a director might reduce the company's total tax bill by £29.75. However, it will also be added to the director's personal income and taxed at his or her own personal marginal tax rate.

#### **1.4 WHAT'S THE DIFFERENCE?**

The major differences between salary or bonuses on the one hand, and a dividend on the other, are:

- Salaries and bonuses usually attract Corporation Tax relief; a dividend does not. In other words, if the company pays you a salary or bonus, its taxable profits will be reduced and it will pay less Corporation Tax. Dividends are simply distributions of company profits after all expenditure and taxes have been accounted for. Paying a dividend does not help the company's tax position because the company's taxable profit is calculated before the dividend is taken into account.
- A salary or bonus is generally subject to National Insurance; a dividend is not. And remember, it's not just the director who pays National Insurance, the company will also have to pay employer's secondary National Insurance as well.
- The rates of Income Tax applying to dividends differ from those applying to salaries or bonuses.
- Income Tax and National Insurance payable on salaries and bonuses is collected through the PAYE system; any Income Tax due on dividends is collected via Self-Assessment – generally at a much later date (but see Section 2.16).
- A salary or bonus will rank as 'earnings' for tax relief on pension contributions. Dividends are not classed as 'earnings'.
- Salaries and bonuses are not expected to be subject to any possible 'income shifting' legislation which may come into force in the future (see Section 16.2); dividends may be.

#### **1.5 SALARY OR BONUS?**

In this guide, I may refer to a 'salary', to a 'bonus' or to both.

As readers will know, a salary is generally paid on a regular basis whereas a bonus is usually a 'one-off' payment.

For taxation purposes, there is no real difference between a salary and a bonus. Both are treated the same way for Income Tax and National Insurance and both are capable of providing the same Corporation Tax relief to the payee company.

Generally speaking, therefore, as far as this guide is concerned, the terms 'salary' and 'bonus' are more or less interchangeable.

In a number of circumstances, however, the payment of some regular salary will be sensible. We will explore this further in Chapter 13.

Bonuses are useful in enabling director/shareholders to 'top-up' their income. Here we will often be comparing a bonus with a dividend against a background where the director already has some regular salary.

The other major benefit of a bonus, as opposed to regular salary, is the ability to influence the timing of Corporation Tax relief on the payment. This does represent one very important difference between a 'salary' and a 'bonus' and we will take a closer look at this idea in Section 6.1.

## **1.6 SCOPE OF THIS GUIDE**

This edition of 'Salary versus Dividends' deals primarily with payments to director/shareholders made, or deemed to be made, during the year ending 5<sup>th</sup> April 2011.

Some reference will also be made to payments made in other years, however. In particular, the guide covers the important twin topics of when to delay payments until a later year and when to bring them forward to the current year: especially important at the moment with marginal tax rates of up to 61% this year and 62% next year!

Over the course of eleven editions, this guide has grown from a simple comparison of the overall net tax burden on bonus or dividend payments to a detailed and comprehensive analysis of the many factors affecting company director/shareholders wishing to extract funds from their company.

This book has been expanded to cover older directors, pension contributions, child tax credits and dividends or bonuses paid in kind. Although most of the calculations in the guide are based on a single company, it does also include a detailed analysis of the impact of any associated companies.

Following the recent legalisation of unlimited loans from private companies to their directors, the guide also now includes a special chapter devoted to examining the benefits and pitfalls of such loans,

with several examples of how to use a loan to save or defer thousands of pounds in Income Tax at minimal cost to the company.

Going further, the guide also provides an examination of the benefits of retaining company funds to enhance capital growth, as well as a look at some of the non-tax factors to be considered when extracting company funds.

It remains important, however, to remember that it is impossible for a general guide of this nature to cover every possible situation. In particular, please note that this guide is aimed only at UK resident director/shareholders owning and working for UK resident companies.

The reader must also bear in mind the general nature of this guide. Individual circumstances vary and the tax implications of an individual's actions will vary with them. For this reason, it is always vital to get professional advice before undertaking any tax planning or other transactions which may have tax implications. The author cannot accept any responsibility for any loss which may arise as a consequence of any action taken, or any decision to refrain from action taken, as a result of reading this guide.

## **1.7 ABOUT THE EXAMPLES**

This guide is illustrated throughout by a number of examples.

Unless specifically stated to the contrary, all persons described in the examples in this guide are UK resident, ordinarily resident and domiciled for tax purposes.

In preparing the examples in this guide, we have assumed that the UK tax regime will remain unchanged in the future except to the extent of any announcements already made at the time of publication, including the Emergency Budget on 22<sup>nd</sup> June 2010.

However, if there is one thing which we can predict with any certainty it is the fact that change **will** occur. The reader must bear this in mind when reviewing the results of our examples.

All persons & corporations described in the examples in this guide are entirely fictional, created specifically for the purposes of this guide. Any similarities to real corporations or actual persons, living or dead, or to fictional characters created by any other author, are entirely coincidental.

## How are Companies and Directors Taxed?

### 2.1 CORPORATION TAX RELIEF

As explained in Section 1.3, it is the marginal rate of Corporation Tax payable by a company which will determine the value of any tax relief obtained for the payment of salary or bonuses. Over the next two sections, we are going to explore in detail how these marginal Corporation Tax rates are derived.

One unfortunate side-effect of the changes proposed in George Osborne's first Budget in June 2010 is the fact that we now have to deal with a staggering 4,749 different possible marginal Corporation Tax rates over a four year period.

Nevertheless, by concentrating on the most likely scenarios, we will be able to produce a picture of the marginal Corporation Tax rates which will apply to the vast majority of companies over the next couple of years.

Some of this will be quite complex and the resultant numbers are not exactly 'pretty', but the principles explored in the next few sections lay the foundation for the results which we shall see in the next chapter when, hopefully, things should become a lot clearer.

As we proceed through the various calculations in this chapter, remember that it is the marginal Corporation Tax rate applying to the company for the accounting period in which the director's salary or bonus is accounted for which determines the amount of Corporation Tax saved by the payment of that salary or bonus.

In most cases, the relevant accounting period is the period in which the salary or bonus is paid. This is not always the case, however, and we will return to this issue in Section 6.1.

## Corporation Tax Rates

Officially, there are just two rates of Corporation Tax applying to most companies: the Small Companies Rate and the Main Rate. For the year commencing 1<sup>st</sup> April 2010, these are 21% and 28% respectively.

However, the Corporation Tax system does not operate in the same way as the Income Tax system. A large company, paying tax at the main rate, does not benefit at all from the Small Companies Rate and will pay Corporation Tax at the main rate on all of its profits.

This is because the benefit of the Small Companies Rate is progressively withdrawn through a system known as 'marginal relief'.

Whilst there are only two official Corporation Tax rates, the practical effect of the marginal relief system is that there are, in fact, actually three effective Corporation Tax rate bands. More importantly, for our purposes, there are also three marginal Corporation Tax rates.

For the year commencing 1<sup>st</sup> April 2010, the marginal Corporation Tax rates are as follows:

Profits up to £300,000:	21%
Profits from £300,000 to £1,500,000:	29.75%
Profits over £1,500,000:	28%

What this means, for example, is that a company with profits of £400,000 for the year ending 31<sup>st</sup> March 2011 will pay 21% on the first £300,000 and 29.75% on the remaining £100,000. The all-important *marginal* Corporation Tax rate for such a company would therefore be 29.75%.

Remember always that the company's marginal tax rate is the rate at which a salary or bonus paid to the company's director saves Corporation Tax.

Many owner-managed companies are subject to the highest marginal Corporation Tax rate, which is currently 29.75%. The only good news to be gleaned from this is the fact that these companies therefore also have the greatest scope for making tax savings.

Note that the £300,000 and £1,500,000 limits set out above must be applied on an annual basis.

Furthermore, where there are any associated companies, the limits must be divided equally over these. For this purpose, we must count all associated companies, including any located overseas. We may, however, ignore any dormant associated companies.

### ***Example***

*Bosworth Limited draws up accounts for a period of nine months ending 31<sup>st</sup> December 2010, during which it has four associated companies. Two of these companies are, however, dormant throughout this period.*

*When applying the Corporation Tax 'bands' set out above, we must first reduce the relevant limits to take account of Bosworth Limited's shorter accounting period. Hence, the £300,000 to £1,500,000 band becomes a £225,000 to £1,125,000 band (i.e. reduced by a factor of 9/12ths).*

*Next, we must allocate this band equally between Bosworth Limited and all of its 'active' associated companies. Bosworth Limited has four associated companies, although two of them are dormant, leaving only two 'active' associated companies. Hence, counting Bosworth Limited itself and its two associates gives us three companies to take into account and a further reduction in the relevant Corporation Tax band limits by a factor of one third is therefore required.*

*So, the band which started life as £300,000 to £1,500,000 and became £225,000 to £1,125,000 due to the shorter (nine month) accounting period involved, now reduces further to a band of £75,000 to £375,000 in order to allow for the company's associates. [ $£300,000 \times 9/12 \times 1/3 = £75,000$ ;  $£1,500,000 \times 9/12 \times 1/3 = £375,000$ .]*

*Now, let us suppose that Bosworth Limited has taxable profits of £100,000 for this accounting period. At first glance one might have thought that its marginal rate of Corporation Tax would therefore be 21% (the Small Companies Rate), as its profits lie in the 'up to £300,000' band. However, having followed the steps set out above, we can now see that the correct marginal Corporation Tax rate band is, in fact, the 29.75% band, because its profits lie in the range £75,000 to £375,000.*

In the above example, I calculated the reduction in the Corporation Tax profit band limits by reference to the number of months in Bosworth Limited's accounting period. In practice, however, this calculation should be done on a more accurate basis, by reference to the number of days in the accounting period.

Throughout most of this guide, I will be concentrating on the position for a single company, with no active associated companies, drawing up accounts for a period of twelve months. It remains vital, however, to remember that the position will be altered in any case where any active associated companies are in existence, or accounts are drawn up for a period of any different length. We will take a further look at the impact of these factors in Chapter 10.

It is also worth noting that company accounting periods may end on any chosen date. It is unusual, however, for a company to draw up accounts ending on a date which is not a calendar month end. We will therefore stick to accounting periods which end at the end of a calendar month throughout this guide.

## **2.2 CORPORATION TAX RATE CHANGES**

The Small Companies rate of Corporation Tax has stood at 21% since 1<sup>st</sup> April 2008.

The rate was due to be increased to 22% from 1<sup>st</sup> April 2011: the last of a series of increases instituted by Gordon Brown in his last Budget as Chancellor in 2007. Thankfully, however, our new Chancellor, George Osborne, has not only scrapped this increase, he has gone even further and reversed it!

Hence, there will now be a reduction in the Small Companies rate to 20% with effect from 1<sup>st</sup> April 2011.

Osborne has also announced a series of reductions in the main rate of Corporation Tax. The current rate of 28% will be reduced to 27% with effect from 1<sup>st</sup> April 2011 and will then be reduced by a further 1% on 1<sup>st</sup> April each year from 2012 to 2014 so that, by 1<sup>st</sup> April 2014, it will stand at just 24%.

Small companies making annual profits of less than £300,000 will only benefit from next year's reduction in the Small Companies rate, but any company making profits above this level will see more significant savings over the next few years.

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