Company bonus or dividend?

In many small companies, the owners are also the directors, and this gives importance to how income is extracted from the company.

Important

The declaration of a dividend has for many years been a strategy adopted by many small businesses.

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 current 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.

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As mentioned above, income tax is chargeable on all profits withdrawn from a company.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. Dividends are taxed on the amount paid by the company. The first £2,000 of dividend is taxed at 0%, with the balance taxed at 7.5% in the basic rate band, 32.5% in the higher rate band and 38.1% for additional rate taxpayers.

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% on earnings between the earnings threshold and the upper earnings limit, and 2% on earnings above this without any upper limit. Employers pay 13.8% on all salaries above £8,424 a year without any upper limit.

Employment allowance

Most businesses, and all charities and CASCs are entitled to an annual 'employment allowance' of £3,000 to reduce their liability for class 1 secondary national insurance contributions. One claim only may be made for companies in a group or under common control. Companies with a single paid employee who is also a director are no longer permitted to claim.

Company law

Salaries can be paid even when a company is making a loss. Dividends may be paid only out of profits for the year, or any undistributed profits from previous years. It is important to ensure that the appropriate documentation and minutes are raised to support the dividend to ensure that this is declared legally and correctly.

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 with the exception of a large company which will pay its corporation tax by quarterly instalments. Additional income tax on dividends 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 details below illustrate the potential advantage of using dividends rather than a salary bonus to extract profits of £10,000 from a small company. The examples assume that the directors are already being paid salaries that take them into either the higher rate of income tax (40%) or the additional rate of income tax (45%). As this is above the national insurance normal upper limit, employees' contributions at 2% and employers' contributions will be payable.

	Higher Tax rate 40%		Additional Tax rate 45%	
	Bonus £	Dividend £	Bonus £	Dividend £
Bonus or dividend	10,000	10,000	10,000	10,000
Employers' national insurance	(1,213)		(1,213)	
Salary available	8,787		8,787	
Corporation tax on £10,000 @ 19%		(1,900)		(1,900)
Dividend		8,100		8,100
Income tax @ 40%	(3,515)			
Income tax @ 45%			(3,954)	
Employees' national insurance	(176)		(176)	
Dividend income tax upper rate @ 32.5%		(1,983)		
Additional rate @ 38.1%				(2,324)

Net amount available	5,096	6,117	4,657	5,776

This example shows an overall saving of £1,021 (40%) or £1,119 (45%) by paying a dividend because the £2,000 nil-rate band is available to use against the dividend.

Scotland: Rates of 41% and 46% apply so this marginally reduces the overall saving.

If more than £2,000 of dividends have been paid already, this changes the position quite significantly; the income tax charge for the higher rate taxpayer becomes £2,633, leaving the dividend better by £371, and for the additional rate taxpayers the corresponding figures are £3,087 and £357.

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.

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'.

Finally, it is important to be aware that the declaration of a dividend may have an impact on the valuation of the company's shares.