MyAccountant.co.uk
your business, your accountant

SALARY VS DIVIDENDS

As a shareholder of a limited company, you are entitled to receive dividends in addition to setting a regular salary to pay yourself.

But what are the differences between these two forms of profit extraction? Both have their pros and cons and have different impacts on the tax paid by both the company and the shareholders/directors themselves. Let's look at both of these and the tax implications.

SALARY

Salary payment is a set amount paid by the company via the Pay as You Earn system. These payments will have income tax and National Insurance (NIC) withheld at source.

The cost of a salary, including any NIC, is treated as an expense for Corporation Tax purposes thereby reducing the company's Corporation Tax liability.

The tax-free personal allowance is offset against salary first with tax paid at 20%, 40% and 45% (depending on the level of your income) and Employees NIC of 12% plus Employers NIC at 13.8%

The level at which you set your salary is entirely your own. However, from a tax efficiency point of view, the lower the salary the more tax efficient you become as you can top up your personal income with dividends.

DIVIDENDS

A dividend is paid from profits made by the company; therefore, if no profits have been made over a given period or there are no undistributed profits brought forward from previous years, no dividend can be paid.

Paying dividends does not reduce the company's tax liability because the company's taxable profit on which tax is calculated does not take the dividend into account.

Generally, an ordinary dividend must be paid to all shareholders of the company. It cannot be paid to just one shareholder in preference to another or be paid at a different rate.

The main advantage of drawing dividends in preference to a salary is that dividends are not liable to NIC either by the company or the shareholder – this reason alone can result in significant savings.

There is a tax-free dividend allowance available to cover the first £2,000, above this amount the tax rate is 7.5% if your income falls in the basic rate tax band.

Dividends paid to a taxpayer that has exceeded the basic rate band incur tax at rates of 32.5% (higher rate) and 38.1% (additional rate).

WHAT IS BEST FOR ME?

The most tax-efficient way of distributing the company profits is to take a low salary combined with dividends.

For example, the minimum salary required to uphold your entitlement to UK benefits such as state pension is the lower earnings limits, which is £6,240 per annum in the current tax year (2020/21).

A higher salary of £9,500 per year would achieve higher corporation tax savings and still be tax and NIC free.

The remaining profit can then be drawn as dividends in the knowledge that it is much more tax-efficient saving both income tax and NIC.