

COMBINING SALARY WITH DIVIDENDS

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If you're thinking of starting a Limited Company, then one of the most crucial things to know is how to take money out of the business while minimising individual and business tax liabilities. This is done by getting the right balance of dividends and salary. Read on to find out more.



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COMBINING SALARY WITH DIVIDENDS

Contractors working through their own Limited Companies can maximise their post-tax earnings by paying themselves a low salary and taking the balance in dividends from their company profits. Further tax efficiency can be achieved by those contractors with a spouse as a shareholder. In this guide, we explain all the ins and outs of optimising your earnings in this way, answering questions such as:

What salary should you pay yourself?

Should you declare dividends?

When should you declare dividends?

Should you be the only shareholder?

Remember though that everyone's circumstances are different, so while this guide will explain the rules, the advantages and the risks, you should speak to a specialist contractor accountant to find the right solution for you.

Understanding the rules of the game

When a contractor wants to take money from their business other than when taking a loan, reimbursing expenses, or when they are closing the business down, it must be taken as a salary or a dividend. Salaries can be paid to any employee but dividends can only be paid to shareholders.

Contractors using Limited Companies are often both employees and shareholders and for this reason they can enjoy the flexibility of choosing how to take their money out.

As well as the split between dividends and salary, a carefully thought out share structure can also reduce the amount of overall tax payable. This level of planning requires a detailed review of your personal circumstances, so read on and ensure you are not missing out on the tax saving opportunities available to you.

CHOOSING YOUR SALARY LEVEL

What is a salary?

When a salary is paid to any employee it is as a reward for their services as an employee and is not in anyway linked to any reward as a shareholder. In most circumstances, salaries are set at an annual level approved by the directors.

Salaries are an allowable expense of the business and are deducted before corporation tax is calculated (in other words they get tax relief). Above certain levels salaries attract employee's and employer's National Insurance contributions, as well as an income tax liability in the hands of the employee.

As a shareholder, employee and director, contractors with their own Limited Company have the control to set their own salary at a level that is most beneficial to them.

Drawing a £Nil salary

Some directors choose to pay themselves a salary of £Nil and take all of their 'earnings' from the business as dividends. As a consequence they pay no National Insurance at all, but this does have other implications to be considered:

Paying a salary lower than the NI threshold may reduce a future entitlement to any state pension and some state benefits

Your maximum personal pension contribution is restricted by your salary level, but you can also contribute from your company with less restriction

If you're not taking a salary, HMRC may argue that dividends paid or declared incorrectly may be 'salary in disguise' and seek to tax them as salary

For these reasons we would advise against a £Nil salary

An appropriate salary

Many directors choose to pay themselves a basic salary up to the limit when National Insurance contributions become payable. For the tax year 2018/2019 this threshold is £8,424 pa.

However, while choosing the level of salary to be paid is a personal decision of the director, remuneration at the National Insurance threshold is lower than the National Minimum Wage.

From 1 April 2018 the National Minimum Wage for persons over 25 years of age is £7.83 per hour, which at 35 hours a week, 52 weeks a year, generates an annual wage of approximately £14,250. While there is no legal requirement for your company to pay you the minimum wage, a salary at this level demonstrates an intention to operate a genuine commercial business, and can be seen as an indication of being outside of IR35. There is no tax benefit for contractors in taking salary in excess of this level except in the case of 'special' circumstances.

Paying National Insurance

Above the minimum annual thresholds National Insurance contributions are due from both the employer and the employee at the following rates.

CLASS 1 EMPLOYERS

National Insurance is paid at a rate of 13.8% of the gross salary for all earnings above the secondary threshold of £8,424 pa.

CLASS 2 EMPLOYEES

National Insurance is paid at a rate of 12.0% on earnings between £8,424 and £46,350. For any earnings above £46,350 in 2018/2019 the rate is reduced to 2%.
National Insurance paid by the employer is also deducted before a company's corporation tax liability is calculated and will therefore get tax relief.

It's now easy to see that there is a balance to be found between paying a salary which (above the minimum levels) attracts National Insurance contributions, and additional payments to shareholders in the form of dividends, which do not attract any National Insurance contributions.

DIVIDEND PAYMENTS

What is a dividend?

Dividends are basically payments made to the owners of the company (the shareholders) from the company's accumulated profits after corporation tax.

Each year that the business trades, any profit (or surplus) after corporation tax stays in the company where, together with surpluses from all earlier years, it builds up. It can be reduced by losses made in any year, or reduced as a result of some other technical reasons, but otherwise it just keeps growing until either the shareholders/directors decide to declare a dividend, or the business is closed and the contracting trade ceases, in which case it would be repaid to the shareholders.

A dividend becomes payable to the shareholders when the directors decide that a dividend should be declared, and it is payable to the shareholders directly in proportion to the shares that each owns. You can only pay a dividend to someone who holds shares in the company, which makes it very important to make the right decisions when you set up your company.

Remember that dividend payments are very different from paying yourself a salary as an employee; your entitlement to dividend payments are entirely dependent on your being a shareholder, and have nothing to do with employment or services provided.

How much dividend can be paid out?

When a company declares a dividend, it can only do so if there are sufficient available profits at that time. You, as director, are responsible for making sure that there are sufficient profits and for factoring in the provision or deduction of corporation tax; so you'll need to have some form of up-to-date management accounts to work out the profits available when you are thinking of declaring a dividend.

You don't have to pay dividends in the year that the profits are made. The maximum amount that can be paid out as a dividend is a running balance of the accumulated profits (less any accumulated losses), less the accumulated dividends previously paid, from the date the company started.

Example

In Year 1 your company made profits after tax of £20,000 but did not pay any dividends and, in Year 2, you made further profits of £30,000 after tax. You could declare a dividend at the end of Year 2 of up to £50,000.

Illegal dividends

A dividend would normally be considered illegal if it's declared by the directors when there is insufficient after tax profits to cover the dividend.

If a dividend is illegal, then there are consequences. Firstly, a director could be found personally liable for any illegal dividend paid if the company goes into liquidation. But what's more likely, is that the illegal dividend becomes repayable by those who ought to have known that the dividend is illegal. That usually includes the contractor and his family shareholders.

The taxman also looks at illegal dividends and says that if it's repayable, then it's a loan... and that may mean they raise a tax assessment on the company for tax of 32.5% of the value of the loan.



How to declare a dividend

Once you've identified that there are enough profits to distribute as dividends, you must then minute the decision to declare a dividend. You must also issue each shareholder receiving a dividend with a dividend voucher.

The dividend voucher acts as a written record – effectively a receipt – showing who got the dividend and how much it was. The shareholder receiving a dividend must keep the dividend voucher as evidence for tax purposes and use it to complete their Self Assessment tax return. The company must also maintain a record of the dividend vouchers produced.

A good contractor accountant will have software and systems that make this process easy.

Who gets paid the dividend?

When a dividend is declared by the directors, they agree how much dividend is to be paid on each share, and then the shareholders receive an amount according to the number of shares they hold. One company can have several classes of share and choose to pay out a dividend to only certain classes; for this reason, choosing the right **share structure** for your company can help to easily direct income to the right person at the right time.

Classes of share

When a company is created, the first shares that are allocated to shareholders are called **subscriber shares**. The directors can issue additional shares later, or they can convert existing shares into several different classes (types) of share, or create entirely new types of share if they wish.

A class of share can be created by simply giving each class a different name and setting out the rights that each class has. Every share within a class of shares ranks equally, and so dividend and voting entitlements of shareholders are determined by the number of that class of shares held.

Dividends, share structures and tax planning

If your circumstances support having multiple shareholders and additional employees other than just you, then with good advice, your share structure can help you make best use of the allowances and lower rates of taxation available every year.

For example, it's common to want to vary the amount of that dividend differently to the ratio of shares actually held, for example where husband and wife, or civil partners both hold shares in the company, or where one shareholder is a higher rate taxpayer while the other is not. The most straightforward and flexible way of achieving this is to create separate classes of share and have each shareholder hold the whole of each class. This means that a dividend can be declared on one or more classes, and in whatever proportion suits the circumstances.

This planning opportunity is popular, but you must seek guidance and ensure that the 'Settlements provisions' legislation is also taken into account. A good contractor accountant can help with this.

When should dividends be declared?

The decision to declare and pay dividends is made by the directors and approved by the shareholders. Provided the profits are available then it should be done at a time to suit the shareholders. The payment date can be very important to shareholders as it determines which tax year the payment falls into. It's the 'paid date' that matters, not the date that the dividend is declared. Therefore, if a dividend is declared on 31st March 2018, but not actually paid until 30th April 2018, then the date of the dividend will be 30th April 2018 and it will fall into the new tax year.



Deferring tax payment dates with dividends

Let's assume you normally don't pay higher rate taxes but one year you need to take more out of your company than normal, such that a higher rate liability would be incurred on the exceptional amount being taken.

If you are careful you can use director's loans as a means to take the money when you need it and then declare a dividend to be payable by offset against the loan taken. So long as this dividend is declared and paid within 9 months after the end of the accounting period, you won't have to pay the tax on an overdrawn loan account.

In this way, you can use the time lag to make the dividend fall into a later tax year and defer the higher rate liability. The same technique can be used if you ever want to defer taxable income from one tax year to another; but be careful...it's very easy to stockpile higher rate tax liabilities if you do not monitor this closely.

DIVIDENDS AND IR35

If a contractor is found to be inside IR35, they cannot use the minimum salary and dividend option for the period of the relevant contracts, and must instead pay themselves everything via a salary.

Personal tax liabilities arising from dividends

When an individual receives a dividend they are receiving income that must be taken into account when working out if they have more personal tax to pay in that tax year.

There is a dividend allowance of £2,000, which means that in the current year you can receive £2,000 of dividend income without paying any tax. Further dividends taken where your overall income from all sources does not exceed £46,350 in the 2018/19 tax year will be taxed at 7.5%. Over and above that, you would be subject to higher rate tax at 32.5%.

Are you subject to higher rate tax?

To work out if you are subject to higher rate tax, you need to look at all of your income before tax was deducted, add everything up and, after deducting any available tax free amounts or other personal allowances, compare the remaining income figure with the tax bands for the relevant tax year.

For 2018/2019 the rates of tax payable on dividends are:

Tax-free 0% up to £11,850*	Basic rate 7.5% up to £46,350	Higher rate 32.5% up to £150,000	Additional rate 38.1% over £150,000
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*Your personal tax-free allowance is £11,850. This will be covered by your salary if you've set it at this or a higher amount, or topped up to that level with a tax-free dividend allowance.

SUMMARY OF DIVIDEND CHARACTERISTICS

- It is common for contractors to pay themselves a modest salary and make up the rest of their required monthly income from taking short term loans from the business.
- Dividends are a payment to shareholders of part of the accumulated profits after corporation tax of the company, and are payable to the holders of the class of share to which the dividend is declared.
- Each shareholder is entitled to receive a dividend according to the number of shares they hold of the class to which the dividend is declared.
- Dividends are personally taxed according to when they are paid. The rates of tax payable on dividend income differ from those charged against earned income (such as salary).
- If the recipient of the dividend is close to higher rate tax thresholds then the timing of the dividends' declaration becomes sensitive, especially around the end of the tax year (5th April).

Conclusions

There is no single salary/dividends formula that will suit all contractors. Your personal circumstances and attitude towards risk will determine the most efficient advice for you.

This guide suggests the opportunities available but cannot consider all the variations in personal circumstances. These would include:

- Your age
- Likely term of contracting career
- The expected and projected income levels now and in the future
- Views on pensions planning and saving
- Family status, including any partner's income
- Other income from outside of the contracting company
- IR35 risk status assessed for each contract
- Cash requirements to fund current lifestyle

Always make sure you seek professional, contractor-specific advice.

HOW INTOUCH CAN HELP

At Intouch Accounting, we work with contractors every day, helping them understand their options, make the right decisions for their business and save money.

Whether you're looking to switch accountants or just starting out in contracting, your dedicated Contractor Accountant will handle everything for you, helping to maximise your income, while staying on the right side of the tax man.



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