Salary vs Dividends – or both?

Many people wonder whether it is better to receive remuneration in the form of salary vs dividends – or just dividends – or both. The tax on dividends (which you pay on income from shares and funds) is lower than the rate you'll pay on money from work or a pension – but the Government announced In September 2021 that it is raising dividend tax rates by 1.25% from 6 April 2022.

Here, we consider what impact the tax changes have for limited companies and whether it is more favourable to take dividends or salary – or both!

The context when considering salary vs dividends

As a director of a limited company, in order to mitigate the cost to you of tax payments on your remuneration, you need to consider options with regard to factors like National Insurance, the benefits of making qualifying payments for the State Pension, the number of people in the business, tax allowances for dividends and income, and tax relief for employee salaries. It's a lot to think about!

There are some advantages and disadvantages to both dividend and salary payment choices and you also need to bear in mind that the Government has frozen some tax thresholds and is also increasing National Insurance, as well as dividend tax rates.

Current benefits of taking a salary

There are three main benefits of drawing a salary as a director of a limited company.

1. You can claim salary as part of your Allowable expenses.
2. These are tax deductible and lower the amount of Corporation Tax your company pays.
3. If you draw a small salary you may not have to pay National Insurance, but could still qualify for various benefits. For example, if you draw a salary which is higher than the Lower Earnings Limit (£6,396 per year in 2022/23) you can build up qualifying years for your State Pension. If your salary meets the National Minimum Wage you could also qualify for employment benefits like maternity pay and other rights.

That said, the thresholds for employer's and employee's National Insurance are different. If you take a salary from the business and it's higher than the National Insurance threshold your company, as your employer, has to pay employer's National Insurance Contributions. And then you, as the employee, would also have to pay National Insurance on your salary – so you're effectively paying it twice..

The NI contribution thresholds for employers and employees are:

2021/22 Employer and employee National Insurance thresholds

Class 1 2021/22 Class 1 (employed) rates

Employee Earnings per week	**%**
Up to £184	Nil
£184.01 - £967	12
Over £967	2

Employer Earnings per week	**%**
Up to £170	Nil

Over £170	13.8 2

Entitlement to contribution-based benefits for employees retained for earnings between £120 and £184 per week. The employer rate is 0% for employees under 21 and apprentices under 25 on earnings up to £967 per week.

Class 1A (employers) 13.8% on employee taxable benefits

Class 1B (employers) 13.8% on PAYE Settlement Agreements

However, employers can use the Employment Allowance to claim up to £4,000 in order to cover the costs of employer's National Insurance. To be eligible, employers must have at least 1 employee, or 2 directors, on the payroll, and the directors must not have another company that is claiming the Employment Allowance already.

What changes impact salary?

From April 2022, an extra 1.25% will be added to National Insurance (NI) for people earning pay or profits over the primary earnings threshold, which is currently £9,568 – but will rise to £9,880 in 2022-23. This will also include those still working and over the State Pension age from April 2023.

So, for example, someone with a salary or profits of £50,000 will be required to pay additional tax of £501 per year and that would be an extra £1,126 if your salary is £100,000.

Using the Income Tax Personal Allowance on your director's salary

Your Personal Allowance (PA) is the amount you can earn before you have to start paying Income Tax . In 2021/22 and 2022/23, the Personal Allowance is £12,570. But the income limit or threshold for PA is £100,000. If you reach the income limit or threshold for PA of £100,000, you will lose £1 of the Personal Allowance for each £2 you earn over £100,000. (The Scottish tax bands and rates are slightly different).

So it can get quite complicated as your income gets higher.

<u>**Understanding dividends**</u>

Dividends are a share of the profits which are paid to business shareholders – so directors who are not shareholders cannot receive dividends. Unlike paying salaries the business must be making a profit (after tax) in order to pay dividends. Also, consider that dividends do not contribute towards building your entitlement to certain benefits, like the state pension. However, they have some great advantages.

The three main benefits of dividend payments are:

1. Dividends are exempt from any National Insurance contributions.
2. They attract a lower rate of Income Tax.
3. You can claim them when you want to (not on a fixed date as with salaries).

Tax-free allowance on dividends

In the 2021-22 tax year, the tax-free dividend allowance for shareholders (the amount you can receive before you have to pay tax on dividend income) is up to £2,000. Above this, you pay tax based on your tax band for any other income/capital gains.

Currently, this is 7.5% (basic rate tax) or 32.5% (higher rate) or 38.1% (additional rate), depending on your other income.

Income between £50,270 and £150,000 is in the higher-rate tax bracket – above that is in the additional-rate tax bracket.

If you earn between £2,000 and £10,000, you'll need to pay HMRC the tax and you can choose to do this via an adjustment in your tax code for your salary or pension, or you can complete a self-assessment tax return. If you earn more than £10,000 in dividends, you have to complete a tax return.

Dividend tax rate changes

In September 2021, the Government announced that the rate of dividend tax will increase by 1.25% from 6 April 2022. That means, if you pay tax on dividend income through your tax code, your dividend tax bill will go up from 6 April 2022. This will be 8.75% for basic-rate taxpayers, 33.75% for higher-rate taxpayers, and 39.35% for additional-rate taxpayers. You still don't pay tax on dividend income that falls within your allowance of £2,000.

To put this in context, currently every £1,000 of company profit taken above the allowance as a dividend would provide a net income of £547 for a director paying the higher rate of tax. From the 2022/23 tax year, this would fall to £497 – a significant sum lost over time!

There are two points which could prove helpful here:

1. If you pay tax through a self-assessment tax return, you'll have until 31 January 2024 to pay the higher dividend tax rates on your 2022-23 dividend income.
2. When calculating how much dividend tax you will need to pay, HMRC will 'stack' your income, taking your income from work, pensions and property into account first, followed by your savings income and then your dividend income. They will work out tax you may owe from any Capital Gains after your income tax. This may mean only your dividends get taxed at the highest rate and tax on dividends is lower than other income.

A word about ISAs

If you hold your shares or funds in a stocks and shares Isa and your *only* income is from investments, you can use your tax-free Personal Allowance as well as your dividend allowance before you start paying tax on dividends. So on top of the £2,000 dividend allowance, you could earn another £12,570 tax-free. However, bear in mind that if you reach the income limit or threshold for PA of £100,000, you will lose £1 of the Personal Allowance for each £2 you earn over £100,000. (The Scottish tax bands and rates are slightly different).

Next steps to take

There are various ways to mitigate tax depending on your situation. Discussing your options with us sooner rather than later will help you make the best decisions, so do **contact us**!