Extraction of Funds – Dividend vs Salary

If you are establishing a new business or you are already a director and owner of a new company, it is vital to consider tax implications and the most effective methods of extracting funds from your business. You must also consider which trading formats are available for you and the consequence of choosing each one.

For an entrepreneur there are **three** available trading formats to choose from: sole trader, partnership and companies (with the most popular for small businesses - limited company).

As a sole trader you are the only person working in your business (you are not able to hire anyone). The biggest issue with being a sole trader is having liability for the debts of the business to the full extent of personal assets (same with a partnership, unless its limited liability partnership).

Sole traders and partnerships are taxed the same way:

Income tax [1]:

Available personal allowance of £12,500 (tax free) up to £100,000 with a claw back afterwards

20%	< £ 37,000
40%	£ 37,501 - £150,000
45%	£ 150,001 >

National insurance (class 2 and 4)

Class 2 – £3 per week

Class 4

Nil	< £8,632
9%	£8,633 - £50,000
2%	£50,001 >

A person earning for example, £110,000, will pay in total £38,579. (£33,500 income tax, NI class 2 – £156 and class 4 £4,923.)

By creating a **limited company,** you will be responsible only for the debt up to the capital contribution. If you are the owner of the company, you can decide to pay yourself a salary or earn only from the dividends of shares.

If either of those options are chosen, the person pays income tax and national insurance (class 1):

NI Class 1 employee

Nil	< £8,632
12%	£8,633 - £50,000
2%	£50,001 >

As an example, if you decide to pay yourself a salary of £100,000 you will pay £33,464 tax (£27,500 of the income tax and £5,964 of NI Class 1)

[1] Gov.uk (applicable through: 1/06/2020-31/03/2021)

In the above two examples we can see that actually in the second case the profit after tax is higher than for the sole trader, even though the sole trader earned more.
However, ….
With the limited company the company also needs to pay taxes: corporation tax of 19% and Class 1 Employer NI of 13.8% - > £8,633. An NI Class 1 Employer is an allowed expense for the company, meaning this can be deducted from the taxable profit.
To make the right decision and to minimize the tax charge you should consider: availability of your personal allowance, any applicable relief (e.g. rollover relief, entrepreneurs' relief), tax rates and other income received for the period.
As an owner of a limited company you can choose to pay yourself a salary or dividends. Dividends income tax rates are smaller – 7.5%, 32.5%, 38.1% and you are not paying National Insurance on them. However, it's not an exempt expense for the corporation tax purposes.
To see this as an example: what happens if you decide to pay yourself £200,000 in bonuses or dividends:
If you pay yourself a bonus you will incur £82,964 of tax (income tax – £75,000 and NI £7964)
If you pay as a dividend £57,775 (income tax - £57,775, no NI)
The company tax will differ too as dividends are not deductible pre corporation tax calculation.

There are a number of factors which need to be considered on top of this information:
Paying dividends is not as simple as paying a salary as you need to comply with the correct legislation[2]. Moreover, dividend payments need to be split equally amongst all shareholders and dividend withdrawals may affect cash flow and possible future investments (expansion). Finally, you must also remember about timings of the dividends.
Please contact us for more information and we can help you move forward in the most efficient manner for your given circumstance.

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[2] Companies Act 1948