REMUNERATION | TAX RATES | PAYE | CORPORATION TAX

Salary vs dividend – which is now best for business owners?

DIVIDEND

Changes to corporation tax have muddied the waters in the debate about the most tax-efficient remuneration options for directors. We look at the pros and cons.

Corporation tax is now 25% for profits over £250,001, with marginal rates at 26.5%. The 1.25% increase in dividend tax rates introduced last year is also still in force. These developments have led many company directors to question whether taking dividends is still more tax efficient than receiving a salary.

Whereas previously the answer has nearly always been yes (dividends are more tax-efficient than salary), the situation is now more complicated – the answer is still yes in most situations but there are now scenarios where salary is cheaper.

We have tried to set out a few 'rules of thumb'* in this article to guide you. However, because this issue is no longer cut and dried, we strongly suggest that you ask for professional advice to ensure you make the most tax-efficient decision for your particular circumstances.

Tax rates

One of the reasons why this question has become so complicated is that, simply looking at the relevant tax rates, paying corporation tax at 25% and then paying the dividend tax rates, results in a total tax rate higher than the total tax cost of paying a salary, as illustrated in Example 1 on this page.

However, for the majority of taxpayers, looking at the actual rates paid is too simplistic.

Why dividends are often still better than salary

The reason why dividends remain cheaper than salary for most taxpayers is due to the amount that is subject to income tax rates, which is around 25% less than for salary (ie, the amount assessed is after corporation tax).

Example 1

	Higher rate income tax		Additional rate income tax	
	Salary	Dividend	Salary	Dividend
Employers NIC (A)	6,063		6,063	
Salary	43,937		43,937	
	50,000		50,000	
Profit before tax (B)		50,000		50,000
Less corporation tax		(12,500)		(12,500)
Dividend		37,500		37,500
Income tax				
– Employees NI	(879)		(879)	
– Income tax	(17,575)	(12,656)	(19,772)	(14,756)
(C)	(18,454)		(20,651)	
Total tax paid (A)+(B)+(C)	(24,517)	(25,156)	(26,714)	(27,256)
	49.03%	50.31%	53.43%	54.51%

**The examples and guidance in this article make several assumptions, the main ones being:*

- *The company has taxable profits at least to the level of proposed dividend/salary.*
- *The taxpayer is below 66 and therefore pays employee's national insurance.*
- *The taxpayer's other income is all salary from the company.*
- *The company pays tax at the top rate of 25%.*

Example 2 on this page demonstrates how a company with a taxable profit of £60,000 that pays a small salary and the balance as a dividend saves more than £6,700 in tax compared with paying the full amount as salary.

In Example 2, the business owner taking the full amount as salary is subject to higher rate tax at 40% on £3,558 of their income (ie, the amount above £50,270). However, the taxpayer taking the dividend route pays no higher rate tax on their dividend as they remain below the limit for higher rate tax.

Therefore, in most situations, despite the marginally higher rates of tax, because of the way income tax bandings work, the dividend route remains cheaper than salary until profits and dividends reach levels in excess of £521,000.

Rules of thumb

- Dividends are generally still cheaper than salary until dividends are above £521,000.
- Drawing a small salary up to the national insurance limit and taking a dividend above this level remains tax efficient for most taxpayers.

When salary is cheaper than dividends

- Where business owners already have £125,140-plus of income, either from salary or another source of income (other than dividends), then a salary will generally be cheaper than a dividend (although it is marginal, at just over 1% cheaper).
- Once dividends are above £521,000, then salary becomes cheaper than dividends.

Other considerations

Although there are situations where salary is now cheaper than dividends, PAYE is payable the following month after the salary payment is made, whereas corporation tax and tax on dividends are collected much later. Therefore, the cash flow advantage or potential interest earned by paying the tax later may be sufficient to mitigate the marginal tax saving.

Summary

The difference between taking a salary and a dividend is now far more marginal than it has been historically, so before making any decisions, take advice from someone who fully understands you and your company's tax positions.

Example 2

	Salary	Dividend
Profit before tax	60,000	60,000
Employers NIC (A)	6,172	-
Salary	53,828	(9,100)
	60,000	50,900
Less corporation tax (B)	-	(9,739)
Dividend		41,162
Income tax		
– Employees NIC	(4,595)	
– Basic rate tax	(7,540)	(3,210)
– Higher rate tax	(1,423)	
(C)	(13,558)	(3,210)
Total tax paid (A)+(B)+(C)	(19,730)	(12,949)
	32.88%	21.58%

A reminder

From 1 April 2023, corporation tax rates changed to:

Profit band	Effective rate
£0-£50,000	19.0%
£50,001-£250,000	26.5%
£250,001 and above	25.0%

And in the 2023/4 tax year for income tax the 0% dividend allowance has reduced to £1,000. The tax rates on dividend income above the allowance are:

Basic-rate tax payers	8.75%
Higher-rate tax payers	33.75%
Additional-rate tax payers	39.35%

R&D tax relief changes come into effect

Claiming research and development (R&D) tax relief can reduce the size of your corporation tax bill, but some businesses may need to adjust their plans to fall in line with changes that have now come into force.

From 31 March this year, the R&D expenditure credit rate increased from 13% to 20%, the small and medium-sized enterprises (SME) additional deduction decreased from 130% to 86% and the SME credit rate decreased from 14.5% to 10%.

From 1 April this year, payments to externally provided workers to carry out R&D only qualify for relief to the extent that those workers' earnings are taxed through the pay-as-you-earn system.

However, from the same date, spending relating to cloud computing and data can be included in R&D tax relief claims. This is a change that will be particularly beneficial for businesses working in the tech and media sectors.

Also from 1 April 2023, businesses must inform HMRC online that they will be making an R&D claim within six months of the end of the accounting period to which the claim relates.

However, plans to restrict R&D tax relief to activities undertaken in the UK with only a very limited scope for claiming any overseas activities have been delayed and will now be introduced from 1 April 2024.

From that date, UK companies that currently claim R&D costs paid to, for example, overseas group companies or overseas third parties may no longer be able to include these costs in their claims. More detail at: *https://tinyurl.com/k8r8nf6b*