Extracting profits as dividends

Dividends provide an opportunity to extract profits in a tax-efficient manner. As a rule of thumb, it is generally tax-effective to take a salary equal to the primary and secondary threshold for National Insurance purposes or the personal allowance (set at £11,850 for 2018/19), depending on whether the employment allowance is available (or the recipient is under 21). Thereafter, it is tax efficient, where possible to extract any further profits as dividends.

However, it is not as straightforward as deciding to pay a dividend rather than a salary and certain boxes must be ticked.

In order to pay a dividend:

- the company must have sufficient retained profits to cover the dividend;
- pay the dividend in proportion to shareholdings; and
- ensure that it is properly declared.

Dividend rather than salary

Once the optimal salary has been paid, the tax hit on dividends is less than on salary. This is predominantly due to the fact that dividends do not attract National Insurance contributions, whereas a salary will attract employee's and employer's National Insurance contributions. Dividends are also taxed at a lower rate of tax than salary payments, and benefit from a tax-free dividend allowance. On the downside, dividends are paid from post-tax profits which have suffered a corporation tax deduction (at 19% for the financial year 2017 and 2018). Even allowing for that, the tax take from paying dividends is lower.

Dividend allowance

All taxpayers, regardless of the rate at which they pay tax are entitled to a dividend allowance. The allowance is £2,000 for 2018/19; reduced from £5,000 for 2016/17 and 2017/18.

The allowance is not an allowance as such, but rather a nil rate band which uses up part of the band in which it falls. Dividends, taxed as the top slice of income, are taxed at a zero rate to the extent that they are covered by the allowance.

Dividend tax rates

The dividend tax rates are lower than the usual income tax rates. Dividends are taxed at 7.5% to the extent that they fall within the basic rate band, 32.5% to the extent that they fall within the higher rate band and 38.1% to the extent that they fall within the additional rate band.

Case study 2018/19

Tim is the director of a family company. He decides to take a salary of £11,850 in 2018/19, which is equal to his personal allowance. He anticipates making a profit of £60,000 in the year to 31 March 2019 and wants to know whether it is better to extract it as salary or dividends.

If he takes a further salary (or bonus), after allowing for employer's National Insurance, he will receive a gross salary of £52,724, the first £34,500 of which will be taxed at 20% and the remainder at 40%.

By contrast, if he takes a dividend, the profit of £60,000 will suffer corporation tax of 19%, leaving £48,600 to be paid out as a dividend. The first £2,000 of this will be tax-free, the next £32,500 will be taxed at 7.5% and the balance will be taxed at 32.5%.

The position is summarised below:

	Salary	**Dividend**
	£	£
Profits	60,000	60,000
Corporation tax		(11,400)
Employer's NIC (£52,724 @ 13.8%)	(7276)	
Employee's NIC ((£34,500 @ 12%) + (£18,224 @ 2%))	(4504.48)	
Income tax – salary ((£34,500 @ 20%) + (£18,224 @ 40%))	(14,189,60)	
Dividend tax ((£2,000 @ 0%) + (£32,500 @ 7.5%) + (£14,100 @ 32.5%)).		(7,020)
RETAINED	£34,029.92	£41,580

By choosing to extract the profits as a dividend rather than as a salary, Tim is more than £7,500 better off.

Partner note: ITA 2007, s. 8, 13 and 13A.