Profit extraction: method 1 - taking a salary

There are various ways of taking money out of a company and each method has its own tax and National Insurance consequences, both for the company and the recipient. In this article, we will look at extracting money in the form of a salary.

Benefits

Taking a small salary can be beneficial from a tax and National Insurance perspective - for both company and the recipient.

To the extent that the salary does not exceed the primary and secondary National Insurance threshold (set at £157 per week, £680 per month, and £8,164 per year for 2017/18), neither the company nor the recipient has to pay any National Insurance.

From the recipient's perspective, to the extent that the salary is covered by their personal allowance (£11,500 for 2017/18), it is tax-free. Thereafter, it is taxed at the basic, higher or additional rates, as appropriate depending on the amount of the salary.

From the company's perspective, both the salary and any employer's National Insurance payable if the salary level is above the secondary threshold, are deductible in computing the profits for corporation tax purpose, generating a corporation tax saving of 19% (financial year 2017 rate).

Another benefit of paying a salary is that, unlike a dividend, it is not payable out of retained profits, and thus a salary can still be paid if the company is making a loss.

Optimal salary

The optimal salary level will depend on circumstance. As a rule of thumb, where the personal allowance is not otherwise utilised, it is beneficial to pay a salary equal to the primary and secondary threshold for National Insurance purposes. For 2017/18, this equates to a salary of £680 per month. The salary will be free of tax and National Insurance in the hands of the recipient, the company will have no National Insurance to pay and the salary will be deductible for corporation tax purposes.

Paying a salary that is between the lower earnings limit for National Insurance purposes (£113 per week, £490 per month and £5,876 a year) and the primary threshold allows the recipient to earn a qualifying year for state pension and benefit purposes without actually having to pay any National Insurance. This is hugely beneficial if the recipient has no other means of earning a qualifying year and does not have the 35 years needed for the full single-tier state pension.

If the company is eligible for the employment allowance (set at £3,000 for 2017/18), and the recipient's personal allowance is available in full, it can be beneficial paying a salary equal to the personal allowance, provided that there is sufficient employment allowance available to shelter an employer's National Insurance liability that would otherwise arise. At a salary equal to the personal allowance, the employee would pay employee Class 1 contributions on the salary in excess of the primary threshold (£3,336 for 2017/18 (being £11,500 - £8,164)) – a National Insurance liability of £400.32 (£3,336 @ 12%). However, the additional salary (as for all salary payments) is deductible in computing the company's profits for corporation tax purposes, so will generate a corporation tax saving of £633.84 (£3,336 @ 19%). The corporation tax saving outweighs the employee National Insurance cost by £233.52 – making it worthwhile to pay a salary equal to the personal allowance rather than the primary and secondary threshold. The same result is obtained if the employee/director is under 21 (or an apprentice under 25), regardless of whether the employment

allowance is available, as no employer National Insurance is payable until the earnings exceed £866 per week (£3,750 per month, £45,000 per year).

Once the personal allowance has been used up, other profit extraction methods are generally more tax efficient, as the tax on the salary combined with the National Insurance cost (even if the employment allowance is available) will outweigh the corporation tax saving.