Salary versus dividends – limited companies advice

Contractors working through their own Contractor Limited Companies can maximise their post-tax net earnings by paying themselves a **low contractor salary** and the balance in **dividends** from their company profits.

Tax rules mean that dividends paid out of limited company profits after corporation tax don't attract further taxation if they are below the higher rate of tax threshold; neither are the dividends subject to National Insurance Contributions (NICs). So contractors effectively pay less tax on dividend payments than they do via salaries.

Contractors whose spouses are shareholders in their limited companies can also make full use of their spouse's tax allowance, by **splitting the basic salary and dividend income** of their limited companies to further reduce their combined tax liabilities and maximise net income.

How salaries are taxed

If a contractor pays a salary above the personal tax allowance of £9,440, the gross earnings are subject to income tax at 20% up to £32,010, at 40% from £32,010 to £150,000, and at 45% for gross earnings over £150,000 (based on tax rates for 2013/2014).

In addition to income tax, contractors also pay 12% of gross earnings in employees National Insurance Contributions (NICs) on all earnings over £149 per week, up to £797 per week, after which NICs drop to 2%.

A contractor's limited company is must also make additional employer's NICs of 13.8% on the contractor's gross earnings taken as salary over £148 per week.

How dividends are taxed

Dividends are how companies distribute profits to shareholders. As long as the company is in profit, it can declare a dividend at any time. Dividends declared when the company is not in profit are called **illegal dividends**, and issues arise. A contractor limited company calculates its profit by deducting expenses from fee income. Corporation tax of 20% is then deducted from profits and the balance can be distributed as a dividend to the company's shareholders, ie the contractor and potentially the contractor's spouse.

The basic rate of tax on dividends is 10%, but because corporation tax has already been deducted from the company's profits, dividend income up to the higher rate tax threshold of £32,010 is considered to be 'franked' by a dividend tax credit, meaning that HMRC considers that corporation tax already paid covers the 10% tax due on the dividend, so a contractor can effectively earn up to £32,010 plus their £9440 tax allowance without paying additional tax.

On dividends paid from £32,010 to the top rate threshold of £150,000 contractors are liable for income tax at a rate of 32.5%, but this is once again discounted by 10% because of the corporation tax already paid, so what a contractor actually pays is 22.5%. Dividends paid above £150,000 have a gross rate of 37.5% tax, discounted to 27.5%.

Crucially, dividends do not attract NICs, so a contractor taking a dividend pays no employee NICs, and their limited company pays no employer's NICs.

Salary versus dividends

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In both cases a contractor can earn up to their personal allowance of £9,440 tax free. But from £9,440 to £41,450 (£32,010 + £9440) a salaried contractor pays 20% income tax and 25.8% NICs; remember a limited company contractor's company also pays 13.8% NICs, which comes out of the contractor's fee income.

Contrast that with a contractor who pays no tax on dividend earnings up to £32,010, and it becomes clear that taking the low salary and dividends route is hugely advantageous for maximising net income and minimising tax liabilities.

Utilising personal allowances by dividend splitting

Contractors who choose to share ownership of their contractor limited company with a spouse or civil partner can benefit from that spouse's unused tax allowances, assuming the spouse has no other income, by 'income splitting'.

A contractor could allocate 50% of the shares to their spouse, and retain 50% for themselves. Because dividends are usually paid according to shareholdings, the contractor would receive 50% of the dividend and the spouse would receive the remaining 50%.

Because the spouse's personal allowances can be used, there is effectively double the amount of tax allowances available. After corporation tax, a contractor and spouse could earn up to £82,900 from a contractor limited company without paying any more in tax or NICs, by choosing the low salary and dividend option, rather than only a salary.

Salary vs Dividends - sample calculations

For this example we compare an £80,000 salary with a contractor who earns £80,000 profit and takes £8,000 as salary and the rest in dividends. We also examine the case where the dividend is split between two equal shareholders.

	Salary	Limited Company One shareholder	Limited Company Two shareholders
Employers N.I.	N/A	41	41
Employees N.I.	4,814	30	30
PAYE	21,818	0	0
Corporation tax	N/A	13,792	13,792
Tax on dividends	N/A	6,263	Zero
Income after taxes	53,367	56,873	63,136

Beware of HMRC applying the settlements legislation (formerly known as Section 660) and IR35

This practice, sometimes called 'income splitting', has at times become controversial. HMRC tried to tackle it by resurrecting the **settlements legislation**, but its plans were thwarted when it **lost the Arctic Systems test case**.

Contractors have also been targeted by **IR35**, introduced in 2000 to tackle disguised employment. If a contractor is found to be inside IR35, they cannot use the minimum salary and dividend option for the period of the relevant contract/s, and must instead pay themselves a salary. To find out if you are caught by IR35 you can use our free online **IR35 Test**.

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