

## Low salary, high dividend profit extraction

### (Lecture B1118 – 14.50 minutes)

Small family companies will nearly always agree a salary to family members within the personal allowance (PA) with dividends on top. If the salary is commensurate with duties performed and made for the purposes of the business, a corporation tax deduction can be taken without creating a corresponding income tax liability. Where both spouses are directors of the company a personal allowance salary should be easily justified.

Some care must be taken as to not trigger an NIC charge for either the company or the employee as the primary earnings threshold for NIC is lower than the PA (the earnings threshold for 2018/19 is £8,424). A payment of earnings between the lower earnings limit of £6,032 and £8,424 will therefore avoid an NIC charge while also creating an entitlement to retirement benefits (as earnings in this band will count toward the employee's contribution record).

If the £3,000 employers national insurance allowance is available it would be advantageous to have a salary of £11,850 pa. A small amount of employees national insurance at 12% will be due BUT the corporation tax relief of 19% on the additional salary will be greater. The employers national insurance allowance will be available unless there is only one individual creating an employers national insurance liability and that individual is a director. Husband and wife companies will therefore be entitled to the employers allowance where both their salaries exceed £8,424.

Regular dividends can be paid to supplement the owner managers salaries. As long as the paperwork supports the fact that dividends are being paid (minutes and dividend vouchers) then there is little chance of regular dividends being reclassified as salary.

With an increasing move to digitalisation the practice of low salary, high dividend will become even stronger. All businesses should have more timely information available to them and this is key to a low salary, high dividend extraction route.

#### *Illustration 1 – Client with software*

Mr and Mrs Hobbs each own 50% of their consultancy company OMB Limited. They are both directors of the company and each draw a monthly salary of £987.50. Mr Hobbs works full time in the business and Mrs Hobbs works around 3 days per week. There are no other employees in the company.

The employers NIC holiday of £3,000 pa ensures that no employers NIC is paid on their salaries.

They each pay employees national insurance of £376pa through the PAYE system of OMB Limited. They appreciate that a salary of £705 per month would secure the same state pension and avoid any employees national insurance but the corporation tax relief on a salary of £11,850 rather than £8,460 is worth an extra £644. This exceeds their employee national insurance bill so a personal allowance salary is their chosen remuneration level.

Mr Hobbs is the main client contact within OMB Limited whilst Mrs Hobbs provides the administrative support. Mr and Mrs Hobbs do not have formal employment contracts with the company so the company will not be bound to pay the national minimum wage to either of them. This would be important for Mr Hobbs who could easily work in excess of 40 hours a week.

Mrs Hobbs's salary might be considered high for three days per week but it should be justifiable given that she is a director of the company. Mr and Mrs Hobbs often discuss key contracts, direction of the company etc. A salary of £11,850 is perfectly reasonable for the role Mrs Hobbs performs.

Mrs Hobbs keeps OMB's records on Xero and as such their monthly numbers are available within a week of the month end.

Every month Mr and Mrs Hobbs look at their results for the previous month and pay dividends based on what they feel is affordable. They consider the monthly profit, the retained reserves in the Balance Sheet and most importantly the available cash.

Their accountants drafted pro forma minutes that Mr and Mrs Hobbs complete for each monthly dividend. A Dividend voucher is prepared at the end of the year.

Mrs Hobbs posts the dividends drawn to dividends in the Xero software.

Their mix of salary and dividends is a sound method of tax efficient extraction and HMRC will have no grounds to challenge their extraction method.

#### *Illustration 2 – Client without software!*

Assume I have a small limited company with minimal retained reserves – essentially a make and take company i.e. whatever they make they extract...

They want a director/shareholder salary of £11,850pa with balance as monthly dividends - but they only know their numbers when their accountants prepare their annual accounts.

How could they ensure that their monthly dividends are "legal"? Given the recent Court of Appeal decision in *Global Corporate Limited v Hale* we must be sure to avoid the possibility of illegal dividends.

Two options:

1. Post the monthly draws to directors loan account. When the numbers are available the accountants prepare paperwork for an interim (or final) dividend to clear loan account.
  - Problem with this is you only have one dividend date so you may have abnormal dividends in a particular tax year.
  - And if the loan ever exceeds £10,000 during the tax year you have a beneficial loan interest charge whilst the loan is outstanding. If numbers were available quarterly then the £10,000 balance may not be exceeded as the loan account is being cleared once a quarter. So monthly draws of £3,000 cleared by a quarterly dividend of £9,000 would avoid a loan interest benefit.

2. Prepare monthly dividend minutes but make specific mention that the levels of profit have been considered. Something like "The directors have considered the levels of cash, debtors and creditors at this point in time and consider a dividend of £10,000 justifiable".

If you have strong retained reserves it does not matter whether you have timely information available as the retained reserves can cover the dividend draws.

I have come across a practice of preparing paperwork at the start of the year e.g. "Monthly dividends of £2,000 will be payable through the year where directors are satisfied that the profit levels justify such a dividend." I am not a fan of this route and would suggest they change their practice to Option 2 above.

*Article prepared by Dean Wootten*