Director's salary or bonus?

Introduction

Given current tax rates, paying a dividend rather than a salary will often be a more cost-effective way of withdrawing profits from a company.

Dividend?

Tax is currently payable on any dividend income received over the £2,000 annual dividend allowance at the following rates:

- 7.5% on dividend income within the basic rate band (up to £37,500 in 2019-20)
- 32.5% on dividend income within the higher rate band (£37,501 to £150,000 in 2019-20)
- 38.1% on dividend income within the additional rate band (over £150,000 in 2019-20)

However, if the company is loss-making and has no retained profits, it will not be possible to declare a dividend, and an alternative will need to be considered. This often involves an increased salary or a one-off bonus payment.

Salary or bonus?

From a tax perspective, the position will be the same whether a salary or bonus is paid. Both types of payment attract income tax at the recipient's relevant rate of tax (20%, 40% or 45% as appropriate).

However, from a National Insurance Contributions (NICs) perspective, the position, and any potential cost savings, will depend on whether or not the payment is made to a director.

Directors have an annual earnings period for NIC purposes. Broadly, this means that NICs payable will be the same regardless of whether the payment is made in regular instalments or as a single lump sum bonus. In addition, since there is no upper limit of employer (secondary) NICs, the company's position will be the same regardless of whether the payment is made by way of a salary or a bonus.

Where a bonus or salary payment is to be made to another family member who is not a director, the earnings period rules mean that it may be possible to save employees' NICs by paying a one-off bonus rather than a regular salary.

Example

Henry is the sole director of a company and an equal 50% shareholder with his wife Susan. In 2019/20 they each receive a salary of £720 per month.

In the year ended 31 March 2020, the company makes profits of £24,000 (after paying the salaries). The profits are to be shared equally between Henry and Susan. They want to know whether it will be more cost effective to extract the profits as an additional salary – each receiving an additional £1,000 per month for the next twelve months - or as a one-off bonus payment with each receiving £12,000.

The income tax position will be the same regardless of which method is used.

As Henry is a director, his NIC position will be the same regardless of which route is taken as he has an annual earnings period for NIC purposes.

Susan is not a director, so the normal earnings period for NIC in a month will be the interval in which her existing salary is paid.

Assuming NIC rates and thresholds remain the same in 2020/21, if Susan receives an additional salary of £1,000 a month, she will pay Class 1 NIC of £120 (£1,000 x 12%) a month on that additional salary. Her annual NIC bill on the additional salary of £12,000 will be £1,440.

However, if she receives a lump sum bonus of £12,000 in one month (in addition to her normal monthly salary of £720), she will pay NIC on the bonus of £585 ((£3,450 x 12%) + (£8,550 x 2%)).

Paying a bonus instead of a salary reduces Susan's NIC bill by £855.

Recommendation

Finally, it is important to note that in determining an effective company profit extraction strategy, tax should never be the only consideration. Any profit extraction strategy should be consistent with the wider goals and aims of the company, directors and its shareholders. With a coherent strategy in place, you will be able to plan effectively for future business growth.

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