

## **HOW DOES IT ALL WORK IN PRACTICE - SALARIES AND DIVIDENDS?**

Many contractors find allocating money between dividends, salary and expense claims difficult and complicated. Often advice given by accountants and HMRC has not assisted.

Life becomes easier if you bear in mind the difference between cash flow on the one hand and accounting for transactions on the other hand. Our advice to our clients is not to worry on a daily basis about the mix between salary, dividends and expense re-imbursements – these can be fine tuned at the end of the tax year. We advise:

1. You invoice your agency on a monthly or weekly basis - see separate section on invoicing for example invoices.
2. When money is received immediately set aside:
  - a. The VAT element if you are VAT registered;
  - b. The estimated tax proportion of the amount after VAT to cover Corporation Tax, Income Tax and NI. It is recommended that the VAT and tax money is saved in an interest bearing account. We can give you a tax percentage if you like, or see appendix 5. Where possible it is often a good idea to over allow, particularly if there is IR35 uncertainty.
3. The balance of the income can be used to meet company expenses, can be drawn as salary or dividend or can be saved. We do not recommend settling living costs, personal expenses or private bills directly from your company – transfer an amount to your private account for living expenses and settle from there.
4. Where income is considered to be outside of IR35 we generally recommend a salary for the main contractor of £8,000 pa and for spouse up to £5,720 pa (2010-11 rates). See further below.
5. Dividends can be taken up to the level of retained profit in the company.
6. The allocation between salary, dividend and expenses can be reviewed and changed addressed at the end of the tax year if necessary. This is normally a two stage process with a pre tax year end review in February/March time for salary levels, and the final tie up of net salary, dividends and expenses as part of the annual accounts.

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### Salary levels

There are no rights and wrongs relating to salary levels, however too high a salary level results in unnecessary NI being paid.

Our current advice is:

- Main contractor £8,000 pa (assuming standard tax code, take home = £620.51 p/m)
- Spouse £5,720 pa (assuming standard tax code, take home = £476.67 p/m)

(2010/11 tax rates)

This is a pragmatic “happy medium” salary level, and in our experience has not caused clients any problems with HM Revenue & Customs.

You can calculate take home salaries at different levels and tax codes using the tools on the Tax Planning section of our [www site](http://www.garbetts.com/psc), [garbetts.com/psc](http://www.garbetts.com/psc).

Additionally if some or all of your income is caught by IR35 then the IR35 rules dictate salary levels.

The NI (employers and employees) payable at various different salary bands (2010/111 rates) is:

Salary	Employers and employees NI
£ 5,000	£nil
£ 8,000	£ 543
£ 12,000	£ 1,495
£ 18,000	£ 2,923
£ 24,000	£ 4,351
£ 30,000	£ 5,779

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### Dividend levels

So long as there is adequate tax reserve in the company, dividends can be as high as you like.

However if you are a Higher Rate tax payer there is often no merit in drawing dividends from your company just to hold the cash personally – you can defer the Higher Rate tax by leaving the money in the company undrawn. In a future year it may be possible to withdraw it more tax efficiently if you were out of contract, taking some time off, or by using a capital payment on closure.

Some of our clients like to restrict their drawings to the starting level of the Higher Rate tax bracket each year. If a £8,000 salary is drawn then the maximum net dividend within the basic rate tax band is £32,280 pa (2010/11 rates) – over that level Higher Rate Tax equates to 25% of the net amount drawn (which in turn grosses up to the difference between the main Higher Rate Income Tax rate of 40% less Corporation Tax / tax credit at source), there will be further liabilities if income exceeds £100,000.

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