

Important Distinctions Between Amounts Paid To Business Owners

Description

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There are various ways in which owners can reward themselves for their efforts in their business. These different amounts paid to business owners carry their pros and cons as well as work under specific circumstances.

For this reason, business owners need to do their research before determining how theyâ??ll be paid. The various implications of your reward structure include;

1. Tax obligations
2. Compliance matters
3. Business value and growth
4. Corporate governance

So, before you indulge in the fruits of your labour, letâ??s look at how you may go about it.

Salaries and Wages

Dividends and Profit Distribution

Allowances

Drawings

Loan Accounts

Salaries and Wages

Salaries and wages are amounts paid to business owners for duties performed in the running of the business. As such, a business owner should only pay themselves if they are involved in the day to day running of the business.

There should be a duty performed that leads to a clear contract of employment for which you are getting paid. Paying yourself a salary with no duty performed is obviously poor corporate governance.

Itâ??s highly unlikely that youâ??ll be opposed as a small business owner as you are likely to be the only shareholder. That is why itâ??s important to put your business first, and only exchange a salary for value.

Additionally, being the director of your company does not entitle you to a salary. Where you are just a ceremonial director with no duties performed, you still donâ??t get a salary. Salaries and wages are subject to standard payroll taxes such as PAYE, UIF and SDI.

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Salaries and wages are some of the more tax efficient methods of compensation. They are an expense on the business, and as such are a pretax deduction. This means that the final amount paid for tax by the business will be less because of the salary.

Itâ??s important to remember though that the more you pay yourself, the less is available as retained profit to reinvest in the growth of the business.

Directorâ??s Remuneration

Company directors are not fully employees of a company, and as such will not always be entitled to the standard rights flowing from an employment contract.

As such, directors have 2 sources of income; a salary they may receive for tendering their services as employees and fees which they receive for performing their duties as directors, e.g. attending meetings.

These combine into directorâ??s fees and remuneration. Directors are not automatically entitled to remuneration for their services for appointment as director. Additionally, a director can enter into a contract of employment with the company and become both employee and director.

As such, you can duly get a salary for the day to day running of your business, and still be entitled to a fee for your director duties. This is important to note because depending on the nature of your company, you may be required to declare these amounts.

The SAICA website provides a list of companies that are required to make this declaration. Additionally, non-executive directors are not employees of the business at all but are independent

contractors.

As such, they need to register for and pay VAT on fees for services rendered to the company. This is only compulsory for fees exceeding R1 Million in any consecutive 12 month period. Non-Executive Directors may however voluntarily register for VAT.

Dividends or Profit Distribution

Whereas the owner you do not perform any duties in the business, the best way to pay yourself is to distribute some of the profits. The important thing to remember is to distribute some, and not all of the profits.

Retained profits are the cheapest and least risky forms of capital. The more you retain, the better you can finance your business growth. Companies usually distribute profits through dividends.

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Sole proprietorships and partnerships simply have profit distribution. Dividends are taxed at a rate of 20%. However, because dividends are taxed on after-tax income, the effective tax rate is 42.4%. This is because the 20% tax is in addition to the 28% tax already paid by the business.

For sole proprietors and partners, profit distributions are taxed as personal income. This means that the tax rate will be determined by the threshold you find yourself in once all your income is summed up.

This can be an important factor in determining what business form to adopt. Because most entrepreneurs start off running sole proprietorships, it can be difficult to determine when to shift.

One factor to consider is to shift once your profit distribution exceeds 42% tax rate for personal income. At the current tax rate, this occurs at a profit share of around +R1 500 000.00 per annum. This is the point where the personal tax rate goes up to 45%.

Allowances

Allowances are amounts paid to business owners in cash or as access to assets or benefits. They can be to facilitate carrying out their duties (allowances), or as a benefit of the job (fringe benefits).

SARS carries a comprehensive list of allowances and benefits employees can get. In a nutshell, where an employer helps an employee meet expenses, an allowance arises. This expense has to be a business expense, otherwise, it would be considered a draw, loan or fringe benefit.

Fringe benefits arise where a benefit is granted to the employee for a lower value than the going market value. This can be assets, funds, services, or even the goods and services of the business.

Generally, all fringe benefits are subject to income tax as part of the employeeâ??s income. There are, however, 2 exceptions, uniform allowance and relocation allowance, if all conditions are met. Allowances are subject to deductions as prescribed by SARS.

Drawings

When sole proprietors and partners meet personal expenses with business funds, itâ??s referred to as drawings. This is so called because it draws down the capital of the business. The biggest challenge with drawings is accounting for them.

Specifically, as the number of transactions grows, it becomes increasingly tedious to know which bills are personal. While some are specific, bills like telephone and meals and entertainment will be tough.

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Additionally, the fact that sole proprietors usually canâ??t have separate business accounts adds to the challenge. Making an effort to separate bank accounts can allow you to account for funds easier by identifying where they came from.

The tax implications of drawings are determined by the amount which you withdraw. Drawings are not taxed in the hands of the business owner, but they are also not a deductible expense. Which means they increase your taxable income, so, in a way they are taxed in your profits.

Because salaries are taxed on a sliding scale while profits are taxed on a fixed scale, the tax obligation of drawings will vary. For lower amounts, drawings yield a higher tax then salaries, and the opposite is true. Amounts paid to business owners as drawings only have a lesser tax obligation where the individual tax threshold exceeds 28%.

As already stated, drawings draw down on the businessâ??s capital. This then results in you having less to reinvest in the business for growth. Particularly where the owner already receives a salary or dividend, drawings should be avoided.

Loan Accounts

As the owner or majority shareholder of a registered company, you can meet your personal expenses using business funds. While this is highly inadvisable and detrimental to the success of your business, it is not illegal.

It is, however, the worst possible way to pay yourself in your business. Not only is randomly taking business money poor management at its worst, but it also carries the worst tax implications, stifles your business growth, and is a nightmare to account for and keep track of.

At first glance, meeting personal expenses with your business account might seem harmless, but it is. With more glances, the implications only get worse. First things first, these amounts used for personal expenses are taxable at law.

The deemed dividend rule dictates that personal expenses in company accounts be viewed as income for the director. A director is deemed to have received a loan from the company when she meets personal expenses with company funds. This gives rise to a loan account for the director. The amount owing to the business at the end of the financial period should, therefore, attract interest, at a minimum of (repo + 1%).

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The difference between the interest charged by the business (which is usually zero) and the interest at (repo + 1%) is a deemed dividend. This deemed dividend is taxable at the standard dividend rate.

The tax rate is less than payroll taxes but you will continue to pay tax as long as you have not cleared the loan. In order to stop paying tax on it, you will need to pay back all amounts in full, which is not really remuneration.

Usually, the tax amount will exceed payroll salaries before youâ??ve paid back the money if you ever do. Additionally, these loans are not business expenses, so they do not reduce taxable income. Insted, they reduce your capital which could have been re-invested for growth. There is really no circumstance where drawing on business funds works well as remuneration.

Conclusion

Whatever you decide to pay yourself and whichever method you use, always remember that your remuneration will affect your growth. Salaries and wages represent a fixed overhead, and will directly affect your profitability. This affects retained profits available for re-investment as capital in the business.

Loan accounts, drawings and dividends, on the other hand, affect your capital directly. So in either scenario, exercise the best principles of corporate governance to ensure the maximum possible growth for your business.

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