

1st Option Dividends Guide

What is a Dividend?

A dividend is a distribution of a Company's profits to its shareholders. This document explains the different ways in which the payment of dividends might affect you.

Who are Shareholders?

Shareholders are the ultimate owners of a business. So, investing in a Company's shares means you are buying part-ownership of that Company.

For example, suppose you chose to invest some money in the shares of British Petroleum PLC, you would then:

- Own a tiny percentage of British Petroleum PLC;
- Be entitled to vote on major decisions;
- Have a say in the appointment of BP directors;
- Be entitled to see the annual accounts; and
- Be able to sell your shares on the London Stock Exchange.

If the values of your shares increases between the dates that you buy them and the date that you sell them, this cash increase belongs to you. It is a capital gain, and would therefore be subject to Capital Gains Tax.

In addition, and all the time you continue to hold the shares, you are entitled to a proportion of any dividends that BP distributes.

How are Dividends Distributed?

Before distributing dividends the directors of a limited Company look at the financial success of the Company. If the Company has had a successful trading period the directors may elect to share some of the financial success with the shareholders of the Company. Dividends are usually paid either annually, six monthly, or quarterly.

The directors look at the profits in the period and then decide how much cash the Company can afford to release. The following example will enable you to see how this works in practice. Please note that this is a very simplistic example of the accounts prepared by a limited Company.

Company income	£1,000,000
Less costs of running the Company	£ 700,000
Profit before tax	£ 300,000
Less Corporation Tax (20%)	£ 60,000
Profit after tax	£ 240,000

The £240,000 is the overall increase in the value of the Company this year. Rather than keeping all of the growth in the business the directors might decide to retain only £140,000 of the profit, distributing the balance of £100,000 to the shareholders.

If you own all of the shares in this Company you would be entitled to the entire £100,000 dividend. If you owned 50% of the shares in this Company you would be entitled to £50,000, etc.

Don't forget, you will also benefit from the fact that your original investment has also increased in value, because the Company has retained £140,000 in profit.

What Does This Mean for the Shareholder?

As an individual you have now received a dividend, probably paid directly into your bank account. In smaller companies this would probably be paid via a cheque, drawn on the Company bank account. In addition, the Company will also prepare and send you a tax voucher. Essentially, this is a certificate that confirms not only the amount of dividend received but also the basic rate tax that it is deemed to have been deducted.

If you are a basic rate taxpayer this year (when all of your various income is added together) you have no more tax to pay. On the other hand, if you are a higher rate taxpayer, then you should be keeping approximately a further 25% of the amount received to cover higher rate tax liabilities.

How Does Higher Rate Tax Work?

If your total income including dividends puts you into the higher rate tax bracket you will need to complete a self-assessment tax return. The tax year runs from the 6th April to 5th April. A self-assessment tax return form must be completed by 31st January following the end of the tax year.

As mentioned in the last section basic rate tax has effectively already been paid on dividends. It is therefore essential to establish how much of your dividend will be subject to higher rate tax and then retain sufficient funds personally to cover that additional tax liability.

In our opinion this is a key calculation and one that you should ask your accountant for assistance with.

The exact income level at which higher rate tax begins is adjusted every year by the Treasury, but assuming that higher rate tax starts at £38,000, lets work through an example. Well, assuming that your employer (your limited Company) has paid you a salary of £20,000 and dividends of £25,000, then:

Income still available at basic rate only (£38,000 - £20,000)	£18,000
Gross dividend income (£25,000 dividend "grossed up" (x 100/90))	£27,777
Gross dividend taxable at higher rate (£27,777-£18,000)	£9,777
£9,777 x 22.5%	£2,200

Your accountant will be able to help you avoid unexpected tax bills, but as a general rule once salary plus net dividends exceeds about £35,000 in a tax year, we recommend that 25% of additional dividend is kept by to cover higher rate tax liabilities.

When is the Tax Due?

If you plan to take significant dividends from your limited Company the timing of the tax payments becomes an important issue. This is because the payments made over to the government are often deferred for almost two years – meaning that it can be easy to forget that the tax is owed. In addition, in the second and all subsequent years it is necessary to make a

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tax payment on account. This has a further bearing on cash flow, and is explained in the following section.

Higher rate tax liability on your dividend receipts are due on the 31st January in the year following tax year concerned. Let's use an example to illustrate this:

Suppose Fred started a Company in April 2007. Fred drew dividends (net) totalling £36,000 during the tax year 6th April 2007 to 5th April 2008. In addition, during the year 2007/8 Fred also drew a salary of £45,000, meaning that all of the dividends would be subject to higher rate tax. Following the formula shown in the previous section we can work out that the 'grossed up' dividend is £40,000 ($£36,000 \times 10/90$), and given that this is all subject higher rate tax, the tax due is £9,000 ($£40,000 \times 22.5\%$).

Now, Fred drew different amounts of dividends at different times during the tax year 2007/8. However, the tax is pulled together when Fred does his self-assessment tax return some time after 6th April 2008. The tax is actually due to be paid over to the Revenue on 31st January 2009.

On Account Payments

In addition, government also collects tax on account. This means that the Revenue assume that a dividend received in one year is likely to be paid again in the second and subsequent years. If we keep Fred in mind, the Revenue assume that Fred will be getting £36,000 in dividends in future years, and will therefore also owe £9,000 in higher rate tax in future years. As a result, what Revenue does is ask Fred to make a tax payment on account, each January and July, for £4,500 (each payment being half the amount that they expect will be due).

It therefore becomes even more important to keep cash sums aside when dividends are received.

Where Does IR35 Fit in?

Separate information relating to IR35 is available should you be in any doubt regards the status of your own contracts.

If you fail IR35 on all of your contract engagements then most of your income will be subject to tax and national insurance. The amount of dividend income is severely restricted by the legislation.

On the other hand, if some or your entire contract engagements Pass IR35, it is likely that you will be able to draw a larger proportion of income as a dividend. The main tax benefit of declaring dividend rather than salary is that dividends are not subject to national insurance contributions.

General Income Advice for IR35 Pass Contractors

Some accountancy firms recommend that those contractors that "Pass" IR35 draw only a minimum wage, and top this up with frequent dividends. We would not agree with this approach.

We would instead recommend that an income be drawn from your Company that is sufficient to meet your domestic needs. If your domestic expenditure (mortgage / rent, bills, school fees,

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food, clothing etc) totals £2,000 per month, we feel it is unwise to draw a minimum wage salary likely to net around £700 per month.

HMRC have a protocol known as 'Commerciality'. This is all about being able to challenge your affairs if you are not running things in what would be regarded as a reasonable commercial basis. Our view is that an insufficient salary is likely to result in a challenge from HMRC. Of course, there is an argument that the Revenue is too busy to review and challenge every contractor, and there is truth in this. However, if and when your Company affairs are reviewed, we feel that you are in a much stronger position if your salary is set at a realistic level.

Once you have set your salary you will then need to consider your expenses and benefit planning. Separate notes are available which discuss the various considerations in relation to claiming expenses and setting up an employee benefits package akin to those received by a permanent employee.

After deciding upon expenses and benefits you will be able to consider your dividends. Let's use an example of a contract income of £1,000 per week.

Company Income	£50,000
Less salary needed to meet domestic needs	£20,000
Less expenses	£ 8,000
Less pension and benefits	£ 5,000
Profit	£17,000

You will see that the Company in this example has made a profit of £17,000. After corporation tax this would leave £13,600 available to draw as a dividend. In this example there would be no additional personal tax liability as salary plus dividend is below the higher rate tax threshold (£20,000 + £13,600).

How Frequently can My Company Pay a Dividend?

There are legally no restrictions of the frequency of dividend distributions made by a Company. Nevertheless, we advise you to draw a dividend on a commercial basis. This means that you should draw a dividend when your Company has built up surplus funds. Assuming your income is reasonably consistent then we would suggest that a quarterly or half-yearly routine of drawing regular dividend amounts is adopted. Of course it is important to check with your accountant in advance of these withdraws that sufficient profits are available.

Naturally, should you wish to discuss matters further, please do not hesitate to contact 1st Option at any time.