

Contractor guide to splitting dividends

To exploit unused personal tax allowances, contractors [running their own limited company](#) and whose contracts are outside [IR35](#) have often maximised net income by splitting the shareholdings in their [contractor limited company](#) with a spouse or partner.

However, as [David Colom](#) of contractor accountant [D J Colom](#) explains, to combat what it perceived by the taxman as 'systemic tax avoidance by contracting couples', HMRC dusted-off the little known [Section 660 settlements legislation](#). Also known as the 'Husband and Wife Tax' or 'Family Business Tax', this dates back to the 1930s and resulted more recently in the infamous [Arctic Systems case](#).

"Contractors can still split the shareholding and thus [dividend payments](#) with a partner or spouse," explains Colom, "but [HMRC](#) now expects to see evidence that the dividend paid to the spouse can be justified through the spouse's active involvement in the company's affairs."

Dividend splitting - how it works

According to Colom, splitting dividends is quite straightforward and simply requires that the contractor's spouse or partner owns a percentage of the shares in the contractor limited company.

"Dividends in small companies are paid out of company profits according to the amount of share each shareholder owns," continues Colom. "If a husband and wife team of two contractors with one company each own 50 shares, and the total number of shares is 100, they each own 50% of the contractor limited company.

He continues: "When a dividend is declared out of the profits made by the company, then each shareholder will receive a percentage of the dividend payment relative to their shareholding." So, using Colom's simple example, if the dividend declared was £10,000 then each contractor in the husband-and-wife team would be paid £5,000.

How splitting dividends can maximise net pay

Where splitting the dividend can bring tax advantages is when a contractor is earning over the higher rate tax (HRT) threshold, and their spouse or partner is earning below it and has an unutilised personal allowance.

Colom's Example 1, below, demonstrates what happens when an entire dividend is paid to one shareholder earning well above the HRT threshold. In this example, the HRT liability is £5,986. That's equivalent to a month's gross fees, and a substantial sum.

Example 1: One shareholder, receiving 100% of the dividends:

	£
Income from contracting	£85,000
Less: Salary paid	-£4,500
Less: Estimated expenses	-£3,035
Profit	£73,464
Less: Corporation Tax	£15,427
Distributable profits, or dividends	£58,036
Additional tax on dividends:	£5,986
Monthly income after taxes:	£4,834

Contrast this with Example 2, below, in which the dividends are split between the fee-earning contractor and a spouse or partner who takes 50% of the dividend, but no salary. Colom says: "The £5,986 HRT liability is wiped out by utilising the spouse's tax allowances, and because basic rate taxpayers receive a 10% tax credit that is designed to avoid double taxation with corporation tax, they have no further tax to pay."

The contractors net monthly income increases to £5,333, from £4,834, because the dividends have been split between a working and non-working spouse.

Example 2 - Two shareholders, 50/50 split of the dividends:

	£
Income from contracting	£85,000

Less: Salary paid	-£4,500
Less: Estimated expenses	-£3,035
Profit	£73,464
Less: Corporation Tax	£15,427
Distributable profits, or dividends	£58,036
Additional tax on dividends:	£None
Monthly income after taxes:	£5,333

Dividends may attract the attention of HMRC and Section 660

However, as in most cases, if it looks too good to be true, then it probably is. Colom warns contractors that HMRC will throw Section 660 at [limited company contractors](#) who can't prove their spouse is an active participant in the business.

"Section 660 was originally created specifically to prevent a high earner from 'settling' income onto a family member, usually, for the purposes of avoiding tax," he explains. "That means if a contractor's limited company is investigated and the spouse or partner taking half the dividend income is clearly not involved in the business, then HMRC will create an assessment on the fee-earning spouse for the full amount of income. This, as we have seen from the examples, can significantly increase the tax burden."

And this scenario is exactly what happened to Geoff and Diana Jones in the infamous [Arctic Systems case](#), although the case was eventually rejected by the House of Lords and [income shifting legislation](#) threatened by the Treasury to tackle family businesses has failed to materialise.

Dividends must be earned to justify income splitting

To avoid being caught in the Section 660 trap, Colom recommends that the spouse or partner becomes a director of the company and plays a significant role in the management of the company. In addition, the share allocation should reflect the work undertaken by the two parties; so this is likely to lead to splits like 60:40 or 70:30, rather than the traditional 50:50.

"The shareholder and director who is not the main fee earner should clearly have a role in the business to justify earning the dividends," Colom adds. "This could be managing administration, so that the contractor is completely free to focus on fee earning, or doing some marketing. A partnership with one director earning fees and the other ensuring they are able to do so and being paid, say, 30% of the dividend is perfectly legitimate."

Colom suggests typical support tasks for a spouse or partner include holding the company minute book, bookkeeping and managing the money, answering calls and correspondence, plus marketing, which might include searching for contract opportunities and running the company website.

Jointly owned shares, share classes and dividend waivers

The tax breaks that used to accompany the joint ownership of shares by a husband-and-wife team versus individual ownership have long since been removed by past Finance Acts, and, according to Colom, complex share classes must be avoided at all costs.

"Since the introduction of the [Managed Services Company \(MSC\) legislation](#), having numerous share classes in a small company has attracted unwelcome attention from HMRC," he says. "Under certain circumstances, this may mean the contractor falls foul of MSC [managed service company] laws, so are best avoided, or only considered after taking expert advice."

[Dividend waivers](#) are also best avoided, as Colom explains: "There is nothing in law that says dividend waivers are wrong, but they are like a red rag to a bull, and in over 50% of cases where clients have used dividend waivers, HMRC has queried them."

As with [JR35](#), the evidence chain is vital. Colom concludes: "Contractors cannot afford to be complacent and, whilst there are still tax advantages to be gained from splitting dividends, measures must be taken to ensure HMRC is not given the opportunity to enact the Section 660 legislation."

Published: Monday, May 10, 2010

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