

Dividends and contracting: calculation, payment and taxation

Why Dividends?

If you are contracting and [running a limited company](#), the most advantageous way to take your income is via dividends, which are the division of profits among shareholders. "In the current tax climate, dividend income is the most advantageous form of profit distribution for small limited companies from a tax point of view," says [Simon Sweetman](#), a tax consultant based in Felixstowe.

Low Salary-High Dividends

Take the [lowest possible salary](#), because salary payments are taxed with PAYE and National Insurance contributions. Then calculate your profit, and divide it up among shareholders according to the rules set up by your company's articles.

When To Take Dividends

You can distribute dividends at any time. You just have to have money in the bank account to do so. But, beware, at the end of your tax year you must ensure that the total of all your dividends taken have been covered by profits earned by the company after all expenditure (including salaries) and [corporation tax](#). If you pay dividends out of untaxed earnings, the Revenue will express its displeasure with your actions.

The Dividend Decision

The decision to take dividends must be approved by the company shareholders in terms of the voting rights as specified in your company's articles. Most contractor companies distribute even amounts of ordinary shares: typically one spouse or partner has 50% and the other has 50% (sometimes, as is recommended, a tie-breaking share is given to someone close to the company in case the two partners fall out). In this case, each partner gets 50% of the profits. If you have a more complex shareholding structure, involving preference shares, or performance-related dividend awards, then you should simply follow the rules you set out in the company articles when you started it.

You can hold a shareholders meeting to vote on dividends, but this is no longer required. You can simply agree among the shareholders to distribute them, and then note the amounts given out in the company's annual records and its accounts (a so-called 'dividend foil,' which is a simple receipt for the dividend paid, is sent out to each shareholder--please see our article on "[Dividend Paperwork](#)" for how to handle this very simple paperwork).

“ In the current tax climate, dividend income is the most advantageous form of profit distribution for small limited companies from a tax point of view ”

Simon Sweetman-Tax Consultant

How To Calculate Dividends

You can take dividends whenever you like and for as much as you like, but you must ensure that the total of all dividends in your company year are not made in excess of the company's profits after corporation tax (called 'distributable profits'). You should keep a running total of the approximate profits generated for the company year and ensure that by year end all dividend payments were only made from taxable profits.

In general terms, the approximate amount of available dividend can be calculated as follows:

	£
Income received from your agent (excluding VAT)	XXXX
Less: Expenses (including salary, employers NIC and all other costs incurred)	XXXX
Taxable profit	XXXX
Less: Corporation Tax @21%	XXXX
Maximum dividend available for distribution to the shareholders	XXXX

You have no obligation to take out the maximum amount; decide how much working capital you may need for your company as well.

IR35 Issues

If you believe your revenue is earned from contracts that are inside [IR35](#), then you must not take dividend income. As a 'disguised employee' you must take your income in salary. If you are in doubt about your IR35 status, evaluate what you do very carefully and see a lawyer. Look closely with the lawyer about what you do on the job, as well as your contracts. Should you take dividend income, and be judged inside IR35, you risk heavy penalties in back tax payments and interest.

In some cases you may have multiple contracts within one tax year, some inside IR35, and some outside IR35. Company profits would then arise only for the income outside of IR35.

How Dividends Are Taxed

How dividends are taxed depends on your personal income (and not on your company taxes).

If you are a basic rate taxpayer--that means with personal taxable income of £36,000 or less--you do not pay tax on dividends. As Sweetman explains: "Dividends are considered 'franked' with a 10% tax rate so they do not affect your personal income tax."

If you are a higher rate tax payer and have more than £36,000 in taxable income, then your gross dividends are taxed at the theoretical rate of 32.5%. But, the dividends you receive are 'net dividends', and taking into account the 10% tax credit results in a further 25% tax due. So, when you declare a dividend as a higher rate tax payer make sure you put aside 25% of it for future tax liabilities.

Splitting Dividends and Income Shifting

As you can see from the above, if you and your spouse each [split dividend income](#) 50-50, you will each have a lower taxable income than if one partner took all the dividends.

That is perfectly normal and acceptable for now, but the Treasury did threaten to put a stop to this practice in the last Budget with proposals about what it called '[income shifting](#).' Don't worry: this proposal didn't go through and for legal purposes, there is no such thing as income shifting. The proposals elicited an outcry from the entire tax and business community because they were unworkable. A consultation period is now under way on income shifting, but many believe the idea will disappear. We all hope so.

“ Dividends are considered 'franked' with tax ”

Simon Sweetman - Tax Consultant

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