Contractor dividend strategies and administration for limited company contractors

If you are a limited company contractor and you fail to keep your dividend paperwork in order, the consequences can be costly. You could be judged by HMRC to be paying yourself a salary and as a result have to pay additional income tax and National Insurance Contributions (NICs), as well as interest and penalties.

"Limited company contractors outside of IR35 will usually pay themselves a low salary and the balance as dividends out of their company's profits," explains James Abbott of contractor accountant Abbott Moore LLP. "That's because you don't pay NICs on dividends, and so contractors' overall tax bills will be lower than if they took the full amount as salary."

But Abbott has a serious warning, as the taxman can reclassify your dividend income as salary and force you to pay more tax. "HMRC has tried to make dividends less attractive by using IR35, Section 660 and S626 and the Managed Services Company (MSC) rules," he explains. "HMRC has two further angles it can take. Firstly it can attack limited company owners where they haven't kept proper paperwork by arguing that the payments aren't dividends at all. Secondly they have another law known as Section 447 on Employment Related Securities to reclassify dividends as salary. That's why you must ensure that dividend paperwork is always accurate and up-to-date."

Contractors and S447

But what exactly is S447? Introduced by HMRC on 2nd December 2004, the tax law Section 447 Employment Related Securities (S447) is designed to prevent companies paying their employees and directors using shares and dividends, rather than a salary.

"When announced, the government said the legislation was designed to attack 'contrived schemes to disguise remuneration to avoid tax and NICs'," explains Abbott. "So, does paying yourself dividends from the profits of your company count as a 'contrived scheme'? In some cases HMRC might set out to try and prove that it does," he warns.

"HMRC has been successfully applying S447 as it should be, hitting large employers using complicated schemes. But HMRC could start putting contractors in the frame for S447," he says. "Therefore, at the very least you need to prove that the money going into your personal account is indeed a genuine dividend and not a salary. You can protect yourself by putting in place a robust paper trail. Even where the paperwork is in place, HMRC might still mount S447 challenges but by having proper paperwork in place at least contractors won't have fallen at the first hurdle."

Dividend administration – minutes and vouchers

Many limited company contractors traditionally declare a final dividend for the entire financial year when their company accounts are completed, which may be many months after the actual year end. "But if you've been paying yourself throughout the year as dividends without completing the formal paperwork, you could come seriously unstuck if a tax inspector investigates," warns Abbott.

According to Abbott, contractors must:

Follow Companies Act requirements by preparing a board minute and dividend vouchers each time a dividend is paid

Ensure there are sufficient profits in the company to cover the dividend. For most contractors, paying a dividend without enough profit is illegal and the company can (and should) ask for the money to be returned.

Abbott provides his contractor clients with a simple 'back of a napkin' dividend calculation: "Add together expenses, salary, corporation tax at 20%, a reasonable margin for error and emergencies, then take the total away from your sales. What remains can be paid to the directors as a dividend.

Never backdate contractor dividend paperwork

"Ideally you should also always write three cheques, or make three separate electronic payments, from your company account into your personal account," says Abbott. "The idea of that is to clearly demonstrate you are paying yourself expenses, salary and dividend. Paying them together in a single cheque could be taken as evidence that any dividends are actually salary"

Never be tempted to backdate board minutes and dividend vouchers, as the documents will be legally void and can constitute a criminal offence. HMRC won't be impressed and, in extreme cases, has been known to prosecute offenders under criminal law.

If you're in the position of having let your dividend paperwork lapse, Abbott advises talking to your accountant, bringing your records up-to-date and establishing a forward schedule to ensure future compliance.

Contractor dividend waivers – best avoided

Another issue to be aware of is dividend waivers. Many contractor limited companies are husband-and-wife teams, and it is common for them to split shareholdings 50:50, which means the tax allowances of both spouses can be fully utilised.

> **The sooner you start keeping 'real-time' records, the sooner you'll be compliant**
>
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James Abbott is the owner of Abbott Moore LLP and often speaks on freelancer / contractor tax matters. He has his own growing portfolio of contractor clients.

Abbott Moore LLP are PCG Accredited Accountants and specialise in providing tax advice to freelancers as well as dealing with their year end accounts and tax returns. **Read Full Profile...**

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"In the past, some shareholders have waived their rights to a dividend to enable other shareholders to benefit from a greater share of dividend income than their shareholding entitled them to," continues Abbott. "However, since the **Buck v HMRC case**, if you tried to use a dividend waiver in this way, HMRC would almost certainly insist the resulting payment to a spouse or other shareholder was a 'settlement', does not qualify for 'spousal exemption' under the **settlements legislation**, and tax you accordingly."

The message from Abbott is clear – invest time in completing the paperwork or suffer what are likely to be very expensive consequences. He concludes: "The sooner you start keeping 'real-time' records, the sooner you'll be compliant."

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