

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 civil partner.

However, as [David Colom](#) of contractor accountant [D J Colom](#) explains, to combat what is perceived by the taxman as 'systemic tax avoidance by contracting couples', HMRC dusted off the little known Section 624 ITTOIA 2005 [settlements legislation](#) (formerly known as Section 660). Also known as the 'Husband and Wife Tax' or 'Family Business Tax', this dates back to the 1920s and resulted in the infamous [Arctic Systems case](#).

"Contractors can still split the shareholding and thus [dividend payments](#) with a spouse or civil partner," explains Colom, "but HMRC now expects to see evidence that the dividend paid to a non-spouse can be justified through the non-fee-earner'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 civil 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 shares 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 civil 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 £7,002. That's equivalent to about month and an a half's gross fees, and a substantial sum.

Example 1 – One shareholder receiving 100% of the dividends (see inset for full calculations)

	£
Income from contracting	£85,000
Less: Salary paid	-£8,000
Less: Estimated expenses	-£3,200
Profit	<u>£73,800</u>
Less: Corporation Tax	-£14,760
Distributable profits, or dividends	£59,040
Additional tax on dividends:	£7,002
Monthly income after taxes:	£4,986

Contrast this with Example 2, below, in which the dividends are split between the fee-earning contractor and a spouse or civil partner who takes 50% of the dividend, but no salary. Colom says: "The £7,002 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 £5,570, from £4,986, because the dividends have been split between a working and non-working spouse.

Example 2 – Two shareholders, 50/50 split of the dividends (see inset for full calculations)

	£
Income from contracting	£85,000
Less: Salary paid	-£8,000
Less: Estimated expenses	-£3,200
Profit	<u>£73,800</u>
Less: Corporation Tax	-£14,760
Distributable profits, or dividends	£59,040
Additional tax on dividends:	£None
Monthly income after taxes:	£5,570

Dividends may attract the attention of HMRC and the settlements legislation

Spouses and civil partners are, under certain circumstances, exempt from the [settlements legislation](#). This 'spousal exemption' means that a fee-earning contractor can gift shares, and resulting dividend income, to a non-fee-earning spouse and HMRC cannot apply the settlements legislation.

Although this exemption was clarified in the Arctic Systems ruling, there are conditions:

The shares must be ordinary shares with full voting and capital distribution rights and the spouse or civil partner must play an active role as a shareholder in the business

The shares must be an 'outright gift', which means any dividends paid to the spouse or civil partner should be their income to spend as they wish and not just a mechanism for routing money back to the main shareholder

The spouses/civil partners must be living together; if living apart, the exemption does not apply.

If the income splitting regime used by the contractor fails those conditions, the spouse could be found to be inside the settlements legislation. Then they might have to consider one of the strategies for non-fee-earning shareholders outlined below.

Dividends to non-spouses must be earned to justify income splitting

The spousal exemption confirmed by the Arctic Systems case only applies to a non-fee-earning spouse or civil partner, and not a non-fee-earning partner, family member or friend.

Therefore to avoid being caught in the settlements legislation trap, Colom recommends that the shareholding non-spouse 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 and not a spouse or civil partner 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."

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David Colom, D J Colom

Colom suggests typical support tasks for a non-fee-earner which is not a spouse 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."



David Colom

Principal

D J Colom & Co Chartered Accountants

David Colom qualified as a Chartered Accountant in the City of London in 1981 and is the founder and principal of D J Colom & Co Chartered Accountants established in 1989.

Started specialising in serving IT contractors in 1993 and is now one of the longest standing suppliers of accountancy services to computer contractors.

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As with [IR35](#), 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, measure must be taken to ensure HMRC is not given the opportunity to enact the settlements legislation."

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