10 facts you need to know about company dividends

Contractors mostly run their contracting business through their own **limited companies**, which are often called personal service companies, or PSCs. There are many benefits of trading this way, which include managing business risk and separating personal assets from the business. There are also tax efficiencies arising through distributing company profits in the form of dividends.

Although the **Dividend Tax changes announced in the Summer Budget 2015** are set to draw a greater tax yield from limited company contractors, dividends still offer a popular, legitimate and tax efficient method of remuneration for contractors.

Here are ten facts you need to know about company dividends:

1. Dividends can only be paid out of company profits

Dividends are paid to the shareholders of a company out of profits or reserves. So, a loss making company with no reserves cannot pay a dividend.

That means, unlike a salary, contractors and other business owners can only pay a dividend when their company is profitable.

2. Declaring dividends without sufficient profits is illegal

Company directors issuing dividends when the company has insufficient profits don't actually have the authority to do so – if they do the **dividend is illegal**.

These are what's known as "ultra vires" dividends, which means 'beyond the powers'. You should ensure there are profits, and involve your accountant if required, before declaring dividends to avoid the risk of breaking the law.

3. Contractors should calculate profits before declaring dividends

To avoid the risk of legal trouble for paying out illegal dividends, you can follow a general rule of thumb to calculate whether you have sufficient profits.

Add together expenses, salary, corporation tax (20% at the time of writing), and a reasonable margin for error and emergencies, before deducting the total from your sales. The remainder can be paid out as dividends.

4. You must correctly record your decision to declare a dividend

Dividends can be paid out to board members at any time throughout the fiscal year, but any distributed dividends must be recorded within the Minutes of the Board Meeting which will form part of your company records.

Similarly, a written record must be kept for each dividend shared – stating the receiver, the amount, and the shares owned by the receiver – known as the "**dividend counterfoil**".

5. Dividends aren't subject to NICs and have lower income tax rates

Limited company contractors often choose to pay themselves through a low salary - within their personal allowance - and high dividend arrangement, as it is the most tax-efficient method.

This is largely due to the fact that dividends aren't subject to National Insurance Contributions (NICs) and Income Tax bands are lower than those paid on a salary.

6. Contractors can still benefit from old tax rates and Dividend Tax Credits

Changes to dividends came into force from April 2016, but before then contractors could continue to benefit from lower (or no) income tax banks alongside a Dividend Tax Credit of 10%. Post April 2016 there are different **dividend tax bands together with a £5,000 dividend allowance**.

7. Dividend Tax changes are due from April 2016

As of April 2016, the Dividend Tax Credit was scrapped and limited company contractors experienced tax hikes on any dividends which exceed the £5,000 tax-free Dividend Allowance.

Tax rates are now:

7.5% for dividends within the basic rate band (£32,000)

32.5% within the higher rate band (£43,000)

38.1% within the additional rate band

8. Corporation tax keeps more dividend income within each threshold

The impact of the Dividend Tax is set to be significant, but possibly not quite as severe as previously feared.

Corporation tax is deducted at 20% before the Dividend Tax. Because the net dividends are no longer grossed up, your dividends will remain in lower tax thresholds for longer.

9. Dividends are set to be less beneficial for husband-and-wife teams

Limited companies run by husband-and-wife teams have traditionally benefitted from the tax advantages brought about by splitting dividends and using two tax allowances.

However, the Dividend Tax changes are set to impact on shareholders individually, potentially costing husband-and-wife teams two lots of extra tax totalling approximately £2,025 each.

10. Beware of S447

The tax law Section 447 Employment Related Securities generally targets large employers using 'contrived' schemes to avoid taxes by paying dividends, rather than salary.

HMRC could start targeting contractors with these rules. As a precaution, you're advised to put in place a robust paper trail to prove that the money you receive is a genuine dividend, and not disguised salary.

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