Increased dividend taxes – time to dis-incorporate?

Limited company contractors considering switching over to alternate trading vehicles to avoid dividend tax hikes may wish to reconsider, as they are likely to be better off staying as they are.

This is according to director of contractor accountants at Intouch, Duncan Strike, who highlights that there are still plenty of reasons for limited company contractors to continue to operate the way they do:

"The dividend tax has eroded only an element of the advantage of operating as a limited company contractor. It hasn't eroded it completely. The big question is: What is the alternative?"

What are the dividend tax changes?

On 6 April 2016, limited company contractors will see tax rates increase on their company dividends. How this affects individual contractors depends on the level of dividends that are taken from their limited company, and their overall salary/dividend mix. Contractors can calculate the direct effect using the dividend tax changes calculator.

The good news is that contractors will no longer need to gross-up dividends when the existing system is replaced with a simple rate of tax on the dividend received. The effect is to lower total income and postpone the point at which income falls into a higher tax band.

Basic rate taxpayers will pay an additional 7.5% in tax, whilst higher and additional rate taxpayers will pay 32.5% and 38.1% respectively. However the first £5,000 of dividends received will not incur any additional tax.

The government's motive for introducing the tax hikes is apparently to narrow the gap in terms of tax paid between employees and limited company contractors, and it has left many contractors pondering alternative working arrangements.

Limited companies aren't the only ones affected by legislative changes

"The most obvious alternative would be to work as an umbrella contractor," Strike continues. "But, as we know, umbrella contractors will also be placed at a disadvantage after April as a result of changes to tax relief on expenses and the new rules restricting mileage, travel and subsistence."

Umbrella company contractors who are deemed to be under the 'supervision, direction or control' (SDC) of the end client will lose access to tax relief on mileage, travel and subsistence expenses from April 2016. Whilst at the time of writing the government is yet to provide sufficient clarity over the definition of SDC, it is widely believed that it will encompass the majority of umbrella contractors.

Meanwhile, further legislative changes mean umbrella contractors will lose access to expenses altogether if it is decided that they are part of a salary sacrifice arrangement, which, as Strike points out, is adopted by many umbrella companies.

"So there will be losses for contractors through dividend tax, but I believe when comparing alternatives that it is easily countered by the loss of tax relief on all expenses that most umbrella contractors will experience."

Strike also insists that other benefits of working through a limited company shouldn't be ignored – notably the advantages of the VAT flat rate, and employer's allowance for companies with more than one employee.

Contractors beware of untested umbrella models

"The real danger I see ahead is that people will start to panic and will perceive the dividend tax as a sum that's so significant that it will no longer be advantageous to work through a limited company," notes Strike, who warns contractors off engaging with umbrella solution providers that attempt to sidestep expenses rules.

"These contractors may look to explore alternative solutions, such as new umbrella models. Now some less reputable and compliant umbrella companies will be providing models that are untested commercially and untested through the tax laws, and they will be presenting these alternatives to contractors through very rose-tinted glasses."

Strike also highlights the costs incurred by umbrella contractors with regards to National Insurance (NI) payments – a rate of 13.8% for employer's NI as well as the employee's NI. By comparison, limited company contractors still appear to be at an advantage.

Limited companies are more credible and less risky

Another alternative option might be the sole trader route. For any contractors considering working as a sole trader, Strike identifies numerous advantages that come alongside the limited company tag.

The first of these concerns client engagement. Contractors are able to present a more professional image by operating through a limited company. This gives clients a greater sense of confidence in engaging with them, inevitably resulting in more work.

Not only this, but Strike also highlights the risk-factor associated with working as a sole trader that often acts as a deterrent for potential clients: “Limited companies ensure that any exchange of services that a contractor undertakes is a business-to-business exchange.

“As a result, the end client is insulated from employment costs and employment taxes should it be determined that the contractor is “employed”. The sole trading option doesn’t provide this protection. As such, it is often perceived to be dangerous by potential clients, resulting in less contracts for the contractor.”

Strike also points towards limited liability, protection of company name and the shrinking Corporation Tax rate for company profits as further examples of benefits of working through a limited company.

Tax hikes will encourage greater discipline and planning

Strike highlights that the incoming dividend tax hikes mean contractors will need to think carefully with regards to distributing dividends, but insists that contractors can mitigate the impact they feel by planning ahead.

“The new dividend tax raises questions with regards to the timing of distributions. It also raises questions as to whether the company has been properly set up and properly considered in terms of its shareholdings.”

Due to the nature of contracting, limited company contractors’ circumstances often vary, and so Strike encourages contractors to speak to their accountants in order to help them identify the most tax-efficient solution that applies to them.

“There are going to be some basic rules to follow as to how contractors manage their dividends and income in order to get the most out of it. But it’s not necessarily as bad as people think it is, with the right forward thinking.”


Duncan Strike

Director

Intouch Accounting

Duncan has successfully developed accountancy businesses for many years. He is an expert in tax law and is passionate about client service and excellence.

Intouch have been championing the cause of Limited Company contractors and freelancers since they were established in 2010. **Read Full Profile...**

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Strike concludes: “At the end of the day, the question of whether or not a contractor should dis-incorporate comes down to the same question they should have asked themselves when they first decided to incorporate: “Do I gain greater freedom and greater flexibility on financial and business matters?”

“Far more often than not, the answer to this question will still be ‘yes’. If that is the case, it’s a pretty straightforward decision.”

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