DIVIDEND TAX SAVING STRATEGIES EXPLAINED

2020/21

Jennifer Adams

taxinsider
BUSINESS

Contents

Dividend Tax Saving Strategies Explained – First published December 2013; second edition May 2014; third edition May 2015; fourth edition February 2016; fifth edition July 2017; sixth edition September 2018, seventh edition August 2019, eighth edition August 2020.

Disclaimer

Disclaimer: This 'Tax Insider' guide is produced for general guidance only, and professional advice should be sought before any decision is made. Individual circumstances can vary and therefore no responsibility can be accepted by the contributors or the publisher, Tax Insider Ltd, for any action taken, or any decision made to refrain from action, by any readers of this guide. To the fullest extent permitted by law, the contributors and Tax Insider Ltd do not accept liability for any direct, indirect, special, consequential or other losses or damages of whatsoever kind arising from using this guide.

About Jennifer Adams

Jennifer Adams FCIS TEP ATT (Fellow) has been a professional business author for over 15 years, specialising in corporate governance and taxation. She is also the proprietor of her own accountancy firm and as such, she is well placed to advise on tax problems that companies and their directors may face.

Jennifer has been a regular contributor to *Business Tax Insider*, *Property Tax Insider* and *Landlord Vision*.

She is the author of the following Tax Insider guides:

- Tax Points for Company Directors Guide
- How to use Trusts to Reduce Property Taxes Guide
- How to Maximise Landlord Expenses.

About this Guide

Used correctly, the withdrawal of monies from a private limited company via the use of dividends can form the basis of an effective tax planning strategy for the directors of those companies.

This guide considers the practicalities involved, with examples and Practical Tips where relevant. It has been updated to include commentary on the impact of the government's Coronavirus grants on the use of dividends.

1 Dividend Payments

The first chapter of this special guide starts by considering the different ways by which monies can be withdrawn from a company by its directors as recompense for their hard work in the running of that company. The text continues by exploring the dividend method to include the taxation of dividends.

1.1 Methods Of Cash Withdrawal

When a limited company is formed, a new entity is created. Legally, this entity is separate from all other persons, including the owners (the shareholders – who can only withdraw profits in the form of dividends), who may or may not be the same people as those who manage the company (the directors who also may or may not be employees of the company).

The methods by which directors can withdraw profits from a company:

- Dividends – if the directors are also shareholders
- Salaries and bonuses (see Chapter 4)
- Director's loan (see Chapter 5)
- Pension contributions
- Reimbursement of expenses
- Benefits in kind e.g. the company pays for a company car
- Payment of rent by the company. Should the owners of the business personally own premises from which the company trades
- Selling assets to the company for value
- Payment of interest by the company on capital invested in the company by a director
- Purchase of own shares
- Liquidation of the company

In a private limited company, it is usual for a director also to be a shareholder and as such payment can be by way of any of the methods given above or by a combination. The aim is to find the method or combination that will result in the minimal amount of tax being paid both by the director/shareholder and the company; this will be dependent upon individual circumstances. As long as the correct procedure is followed, confirmed by the correct paperwork, then effective tax savings can be achieved.

1.2 What Are Dividends?

Dividends are effectively a reward given to shareholders for taking the risk of investing in the company.

Dividend payments are not automatic and, in the absence of any provision to the contrary, dividends must be paid in proportion to the shares held by each shareholder of each class of share. A dividend is paid from retained profits made by the company, therefore, if there are no undistributed profits brought forward from previous years and management accounts show no profit for the period during which the dividend is to be paid then there can be no dividend.

It is important to appreciate that dividends are not earnings and as such are not taken into account when calculating the amount of pension tax relief available; neither do they count as contributions towards the state pension. In addition, it was because dividends are not earnings that the Coronavirus Job Retention Scheme did not support dividend payments. Again, taking the point that dividends are not a reward for services, means that dividends cannot be factored into a Research and Development (R&D) claim and are therefore not deemed to be a tax-deductible cost.

Practical Tip

Shareholders spending substantial amounts of time on R&D projects may wish to consider switching to payment entirely in salary as the extra Corporation Tax relief generated through an R&D claim may outweigh the National Insurance cost.

1.3 The Taxation Of Dividends

For 2020/21, the first £2,000 of dividend income is taxed at zero rate (termed the 'Dividend Tax Allowance' ('DTA')) with the balance taxed at the rates shown below. The DTA is not, in fact, an allowance; rather, it is a zero rate of tax applied to the dividend income only of all taxpayers, regardless of their marginal tax rate.

Dividends in excess of the DTA are taxed at:

- 7.5% if the highest rate of tax is the basic rate band
- 32.5% if in the higher rate band (i.e. over £50,000 gross income)
- 38.1% if in the 'additional rate' band (over £100,000 gross income)

As dividends are taxed at the taxpayers' highest tax band, the availability of the DTA could result in £2,000 of dividends being taxed at 0% with the remaining dividends being taxed at 32.5% should the taxpayer be a 40% higher rate taxpayer.

If the personal allowance has not been used against other income then it is possible to offset the allowance (or balance of unused allowance) against any dividend income in addition to the DTA. For 2020/21, this could mean that dividends amounting to £14,500 are tax-free (i.e. £12,500 + £2,000).

Practical Tips:

- amounts paid by way of a dividend are not deductible in computing the tax liability of a company, as they would be should the payment be in the form of a salary or bonus
- to be allowed to declare a dividend, the company must ensure that there are sufficient distributable profits available (see section 1.4 '*Types Of Dividend*', section 1.5 '*Method Of Dividend Payment*' and section 7 Trap 2 '*Distributable Profits Must Be Available*').

Further detail, including text on the impact of the DTA in various scenarios, with examples, can be found in chapter four *'Salary v Dividends – Which One Or Both?'*

1.4 Types Of Dividend

Companies Act 2006 S 830 (2) states that '*a company may only make a distribution out of profits available for the purpose*' – this is legal speak for the fact that a company needs to have sufficient 'distributable profits' to cover the dividend at the date of payment. This figure is the amount remaining after the company has paid its corporation tax.

Once it has been established that there are distributable profits available and it would be beneficial for the withdrawal of profits to be in the form of a dividend, then payment can be made.

Practical Tip

Dividends do not have to be taken in cash; the company could declare a dividend of a specified cash sum, which is then satisfied by the transfer of an asset (termed a dividend 'in specie). However, the company will still need to ensure that it has sufficient distributable profits to satisfy the value of the asset (see 1.5 *Method Of Dividend Payment*).

Interim dividends can be declared at any time before the annual profits have been computed, usually on a six-monthly basis but they can be paid monthly or quarterly.

A **final dividend** is one that is declared by being included in the company's accounts at the end of the company's accounting year.

Practical Tips

- Under company law, directors are permitted to authorise payment of interim dividends, however, final dividends must be approved by ordinary resolution of the Board of Directors confirmed by a simple majority of shareholders; this can now be done in writing/email, no formal meetings being required.
- It is recommended that 'management' accounts be prepared before the declaration of the dividend is made to ensure that sufficient distributable profits are available as at a date of payment. The reason for this is that there may be a situation where a company's last annual accounts showed distributable profits and then an interim dividend is paid on the assumption that similar profits are being made in the current accounting year. However, should the final accounts for the current year show no distributable profits but instead show losses then no distribution can be made unless it can be proved that sufficient profits had been available at the time of payment. For detail, see section 2.2 '*The Company Must Be In Profit*'.

1.5 Method Of Dividend Payment

The payment of dividends is usually governed by a company's Articles of Association. The majority of private limited companies adhere to the Model Articles in which there is a separate section of six clauses relating to the procedure and payment of dividends.

On the granting of a dividend, the money cannot just be withdrawn from the company's bank account as there are procedures that must be followed to ensure that the payment is legally compliant. In addition, HMRC is increasingly contending that dividends are, in reality, earnings and to persuade them otherwise needs proof that a set declaration procedure has been followed.

Having a credit balance in the bank account is not enough – profits must have been earned. Any dividend paid in excess of this profit or paid out of capital or when losses have been made is termed *'ultra vires'* and is, in effect, *'illegal'*.

Note: The second chapter of this guide (*'Illegal And Illegal Dividends'*) investigates the term *'illegal dividend'* and explains what needs to be done to ensure that the payment is *'legal'*.

Over an accounting year, a director (or any other 'participator' i.e. anyone who has an interest in the company) may withdraw monies from the company; this is made possible via the use of a 'Director's Loan Account' for which records must be kept every time an amount is withdrawn. The director in effect 'borrows' money from the company and at the end of the accounting year, a calculation is made to settle the loan which can be in the form of salary and/or dividend. Dealing with directors' loans can be complicated - further detail can be found in chapter five *'Using A Directors Loan Account 'Correctly''*.

Only a director or participator can use this method of extraction. A shareholder who is not a director or a participator receives payment via dividend only and that dividend must be paid to all shareholders holding the same type of shares in proportion to their shareholding. A dividend cannot be paid to one shareholder in preference to another or be paid at a different rate unless the shares are of a different class (termed 'Alphabet' shares). However, it is possible to waive dividends. The use of dividend waivers and 'Alphabet' shares is explored in chapter three *'Tax Planning'*.

1.6 Payment Dates

The dividend must not exceed the amount recommended by the directors. The date of payment of a dividend is especially relevant should, for example, the shareholder be a basic rate taxpayer (or not be a taxpayer) in one tax year but a higher rate taxpayer in the following tax year.

Practical Tip

The availability of the 'Dividend Tax Allowance' for each tax year combined with the differing payment dates for interim and final dividends can be used in tax planning to tax dividends in a lower tax rate year (see 4.6.1 *'Advantages Of Dividends V Salary/Bonus Withdrawal'*).

- **Interim dividends**

The relevant date for tax purposes of an interim dividend is the actual date of payment because no Board resolution is required as confirmation. It can be paid at any time at the directors' discretion so long as the company has sufficient distributable reserves. The date of payment can be varied or rescinded at any time and will only be regarded as *'due and payable'* when it is actually paid or is otherwise unreservedly placed at the disposal of the directors/shareholders.

Practical Tip

An interim dividend can be paid by credit to the director's current account. This is confirmed in HMRC's *Company Taxation Manual* at CTM15205, which states:

'Payment is not made until such a right to draw on the dividend exists, expected to be when the appropriate entries are made in the company's books. If such entries are not made until the annual audit, not uncommon in a small company, and this takes place after the end of the accounting period in which the directors resolved that an interim dividend be paid, then the due and payable date is in the later rather than the earlier accounting period.'

- **Final dividend**

The Model Articles provide that the directors must recommend payment of a dividend and then an ordinary resolution must be passed by the shareholders in general meeting as approval of the director's recommendation. The relevant date for a final dividend is the date of the general meeting unless a later payment date is specified in the resolution.

A final dividend that has been properly declared but no payment date specified creates an immediate enforceable debt. In this situation, the dividend is recognised for tax and legal purposes as being paid on the date of declaration. Should the Articles specifically provide that dividends are not to be declared using this method then the directors can declare the dividend without needing to obtain the consent at a shareholder's general meeting under their general powers as directors.

Practical Tips:

- Rather than miss a date of payment, a standard dividend resolution text could be prepared which states that the accounts have been prepared and considered and that there are sufficient profits available for a dividend to be declared. This resolution will then provide the authorisation for any dividend payment to be made at a set date (e.g. the resolution could include the statement '*the dividend is deemed to have been paid 14 days after the date of signature*'). The resolution would only need the date and signature of a director to be validated
- A note to the accounts could be made confirming that after due consideration the directors confirm that there was sufficient profit to enable a dividend (s) to be paid
- When a resolution agreeing to a final dividend is passed the date of payment can be deferred, the payment of which will then be taxable in the hands of the shareholder

1.7 The Dividend Counterfoil

The sole purpose of the dividend counterfoil is to provide a record for the dividend receiver. It is not a legal document. Rather, it is simply a written confirmation record stating who has received the dividend, how many shares