WHERE ARE WE NOW?

Peter Rayney explores how the new dividend regime coming into force in April will affect tax liability for owner managers

For many years now, owner managers have enjoyed reasonable tax rates on extracting dividend income from their companies. Indeed, the vast majority of owner managers have continued to pursue a 'low salary/high dividend' model of income extraction.

In the Summer Budget 2015, the Treasury told us that the imputation system of taxing dividends was no longer sustainable since it was 'designed more than 40 years ago when corporation tax was 50% and the total bill on dividends for some was over 80%'. Most tax pundits expected some levelling of the 'fiscal' playing field since we had got to the stage where earnings were taxed more heavily than dividend income.

The result is that – on 6 April 2016 – we will have an entirely new dividend tax regime, which is set to send some seismic shocks through our tax landscape. Inevitably, owner managers will be forced to rethink their cash extraction methods. These tax changes also apply to all other forms of distributions made by a company. For simplicity, in this article, dividends and other distributions are collectively referred to as dividends.

KEY CHANGES

The main aspects of the new dividend provisions are summarised as follows:

- Dividends do not carry any form of tax credit. The cash dividend or value of the distribution received is reported on the tax return (there is no grossing-up). The current 10% tax credit carried with dividends will be abolished on 6 April 2016.
- Taxpayers benefit from a £5,000 dividend tax allowance, which effectively represents a 'nil-rate' band for dividend income. Dividend income is treated as the highest slice of income and is allocated to the various tax rate bands before taking the £5,000 dividend allowance into account. Dividend income cannot benefit from the current £5,000 savings allowance.
- Subject to personal allowances and the £5,000 dividend allowance, dividends are then taxed at the following rates (the corresponding current 2015/16 effective rates are also shown for comparative purposes although the tax bands are not the same):

Dividend tax rates – 2016/17

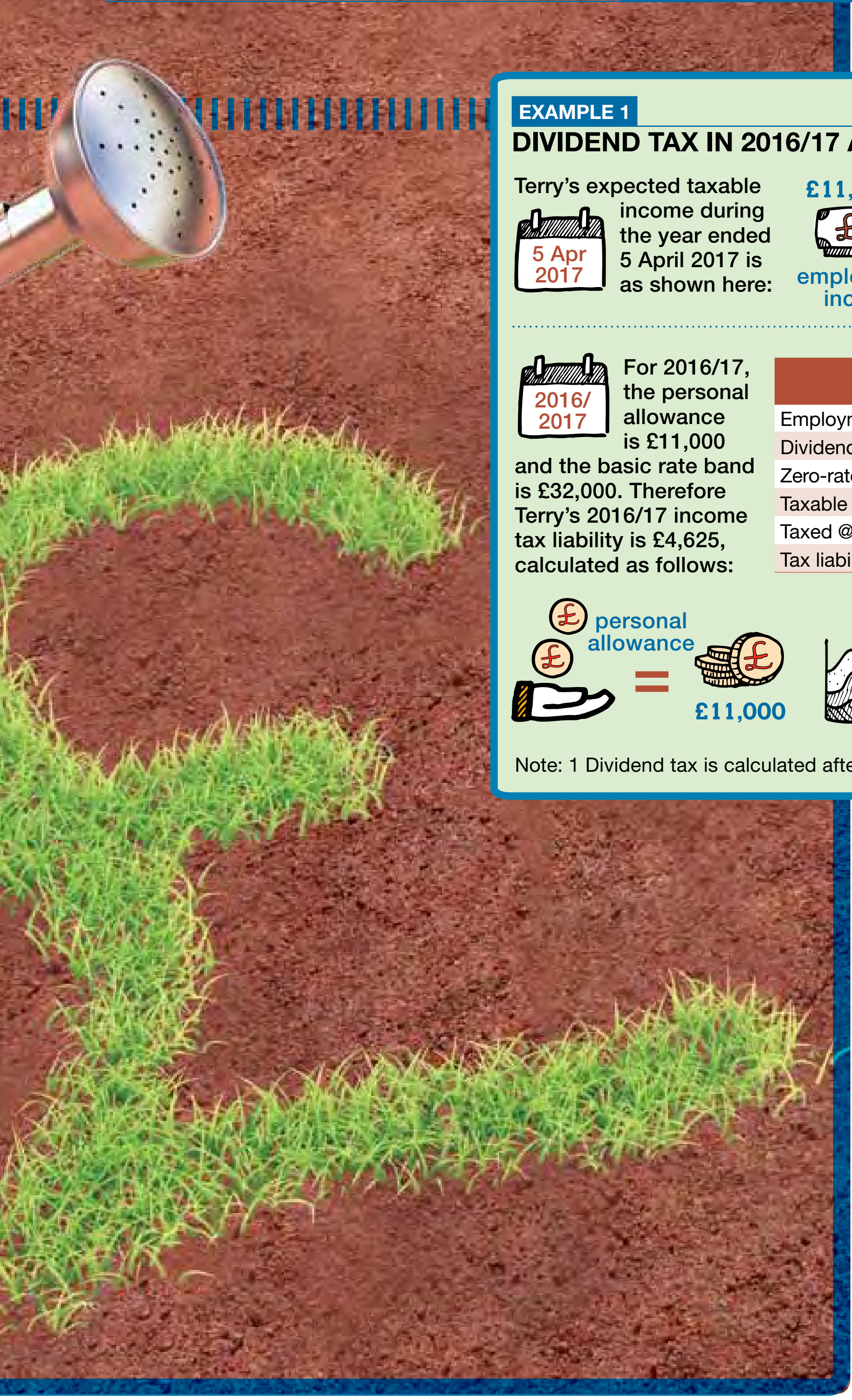
Taxable dividend income received	Tax rate	Comparable rate 2015/16
< £32,000	7.5%	Nil
£32,000-£150,000	32.5%	25.0%
> £150,000	38.1%	30.6%

The new post-5 April 2016 dividend tax rates represent a 7.5% increase on the comparable 2015/16 rates. A number of owner managers have, therefore, taken action or are contemplating steps to mitigate the increased tax cost of taking dividends after 5 April 2016 as detailed in this article.

PRE-5 APRIL 2016 DIVIDEND PLANNING

Owner managers may wish to consider accelerating dividend payments before April 2016 to benefit from the current lower dividend tax rates, although this may not suit everyone. The same considerations will apply where an overdrawn director's loan account is likely to be cleared by a dividend payment taken after 5 April 2016 (within the relevant nine-month window following the balance sheet date). In many cases, it will be more tax-efficient to do this by paying the dividend before 6 April 2016.

Detailed calculations should be prepared in each case to determine whether the tax savings are worthwhile, also taking into account the acceleration of the tax charge by (at least) one year. For example, if an owner manager were



EXAMPLE 1

DIVIDEND TAX IN 2016/17 AND £5,000 NIL RATE BAND

5 Apr 2017

Terry's expected taxable income during the year ended 5 April 2017 is as shown here:

£11,000 employment income → Terry ← £40,000 dividend ← Bewlay Brothers Ltd

2016/2017

For 2016/17, the personal allowance is £11,000 and the basic rate band is £32,000. Therefore Terry's 2016/17 income tax liability is £4,625, calculated as follows:

	Total	Personal allowance	Basic rate	Higher rate
Employment income	£11,000	£11,000	-	
Dividend income	£40,000		£32,000[1]	£8,000
Zero-rate dividend band	£(5,000)		£(5,000)	-
Taxable dividend	£35,000		£27,000	£8,000
Taxed @			7.5%	32.5%
Tax liability	£4,625		£2,025	£2,600

personal allowance = £11,000

basic rate band = £32,000

Terry → £4,625 income tax

Note: 1 Dividend tax is calculated after taking into account the £5,000 dividend allowance

a top-rate taxpayer, every £100 of dividend brought forward into 2015/16 from 2016/17 (or later) would save tax of £7.50 (£100 x 38.1% less 30.6%).

On the other hand, many owner managers may suffer a 30.6% rate by bringing dividend payments into 2014/15, which may not be worthwhile if that dividend is likely to fall within 'their' 32.5% dividend rate band in 2016/17.

Assuming it is beneficial to accelerate dividend payments (well) before 6 April 2016, owner managers must ensure that 'their companies have sufficient distributable profits to "frank" the required dividend payment'.

For 'interim dividends', the date of actual payment is taken to be the (due and payable) 'tax point' (see *Potel v IRC (1970) 46 TC 658*).

It is also important to observe the proper Companies Act formalities, such as directors meeting and recording minutes, etc.

In the context of a 'small private company' (where the directors and shareholders are the same), HMRC takes the view that dividends can be treated as paid when 'a right to draw on the dividend exists', such as when they are credited to a shareholder/directors loan account (see HMRC's Company Tax Manual (CTM 20095)).

Of course, the relevant credit might not be made until a later accounting period, such as when the company's statutory accounts are prepared. For these reasons, a 'belt and braces' approach would be to ensure physical payment of the dividend at the relevant time with the subsequent loan-back of those funds to the company (with an appropriate credit to the owner manager's/shareholder's loan account). It will be appreciated that the 'cash dividend' can, therefore, be reinvested back in the business if the funds are required for working capital or future investment.

THE £5,000 NIL RATE BAND

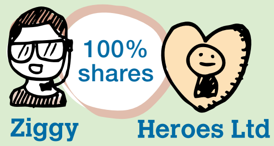
Under the new dividend tax regime, everyone has a nil tax rate band of £5,000 for dividend income, which is often referred to as the £5,000 dividend allowance or exemption. However, it is best to consider this as a 'nil rate' band, since the allocation of dividend income (which is treated as the highest slice of income) across the various tax bands takes place before taking into account the £5,000 nil rate band, as shown in example 1.

COMPARISON WITH BONUSES/EARNINGS

For many years, owner managers have generally preferred to 'draw' most of their company's » 32

EXAMPLE 2

BONUS V DIVIDEND EXAMPLES

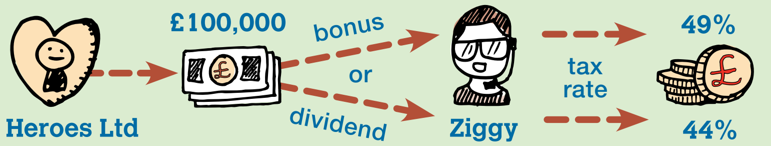


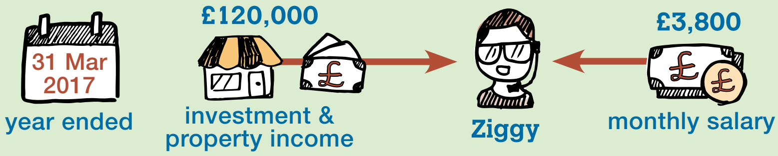
Ziggy owns 100% of the share capital in Heroes Ltd.

During the year ended 31 March 2017, he received a monthly salary of £3,800 and he had no other income.

Before the March 2017 year end, he wishes to extract £100,000 of 'surplus' profits from the company. The overall tax costs of taking the £100,000 as a bonus or dividend calculated as:

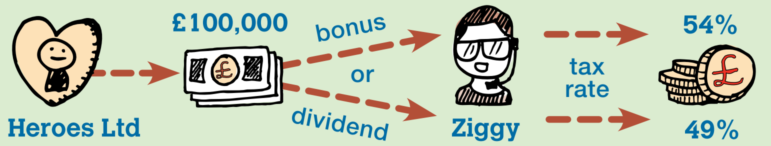
Higher rate taxpayer	Bonus	Dividend
	£000	£000
Surplus profits	100	100
Less employer NIC @ 13.8%	(12)	
Less corporation tax @ 20%		(20)
Paid to Ziggy	88	80
Income tax @ 40%/32.5%	(35)	(24)[1]
Employee NIC @ 2%	(2)[1]	
Net cash available	51	56
Effective rate	49%	44%





However, if Ziggy also had (say) £120,000 of property and investment income in 2016/17, the tax costs of taking a bonus or a dividend would be calculated as follows:

Top rate taxpayer	Bonus	Dividend
	£000	£000
Surplus profits	100	100
Less employer NIC @ 13.8%	(12)	
Less corporation tax @ 20%		(20)
Paid to Ziggy	88	80
Income tax @ 45%/38.1%	(40)	(29)[2]
Employee NIC @ 2%	(2)[1]	
Net cash available	46	51
Effective rate	54%	49%



Notes: 1 Marginal employees' NIC rate. 2 Dividend tax is calculated after taking into account the £5,000 dividend allowance

profits through dividends rather than earnings/bonuses. As a result of dividend tax rates increasing from 6 April 2016, it is instructive to compare the overall tax costs for dividends and bonuses for 2016/17. This is best done by way of a worked example for a '40%' and '45%' taxpayer (see example 2). On the basis that a 'commercial salary' is paid, it will be seen that the overall tax cost of paying dividends is slightly lower than paying bonuses.

Under the new regime, owner managers are still expected to prefer dividends to bonuses. Cautious advisers still advocate paying a reasonable level of salary as well. (Using 2015/16 tax rates, around a 9% tax saving would be enjoyed by paying a dividend).

However, the new dividend rates are likely to reduce the appetite for arrangements designed to pay 'senior employees/management' dividend income (as opposed to their full commercial salaries/bonuses), such as 'alphabet share' schemes.

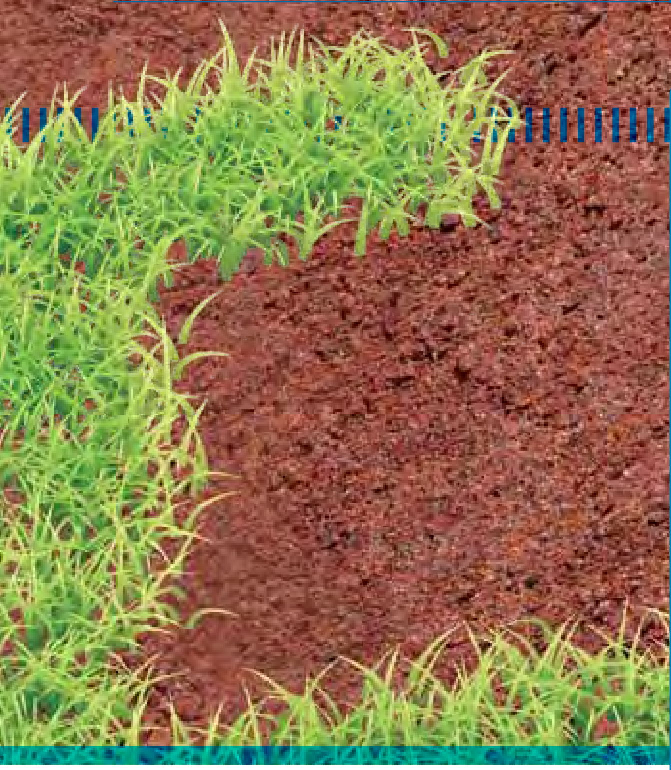
SPOUSAL DIVIDENDS

Spousal dividend planning should remain effective after 5 April 2016 provided it is implemented properly. This means ensuring that the spouse holds/receives ordinary shares in the company (carrying the full range of rights, such as voting, entitlement to capital on a winding-up or on sale, as well as dividends).

Thus, where the transfer or issue of shares to the spouse constitutes a settlement (as will invariably be the case), the spousal 'outright gifts' exemption [s626 Income Tax (Trading and Other Income) Act 2005 (ITTOIA 2005)] will protect the dividend from being treated as the (settlor) husband's income (as confirmed by the House of Lords ruling in *Jones v Garnett [2007] UKHL 35*). Example 3 illustrates the benefit of paying a dividend to a spouse in 2016/17.

Owner managers may also wish to consider the potential benefits of gifting shares to their 'adult' children. It will normally be possible for any capital gain arising on the deemed market value of the gifted shares to be held over under s165, Taxation of Chargeable Gains Act 1992. Under the new dividend rules, each child would have their own £5,000 nil and 7.5% dividend 'tax-rate bands'.

Consequently, dividend payments made to an adult child of up to (say) £38,000 would produce relatively low tax liabilities (as illustrated in the example above). Parents may find this strategy a less painful way of financing the increasing costs

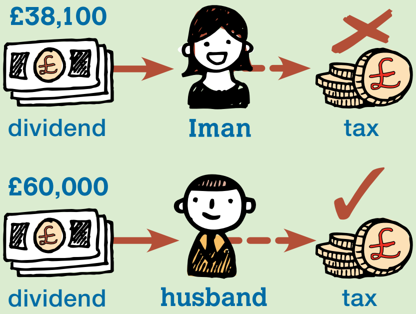


EXAMPLE 3
SPOUSAL DIVIDENDS – 2016/17

Iman owns 40 B ordinary shares in Hunky Dory Ltd and her husband owns 60 A ordinary shares.

2015 / 2016

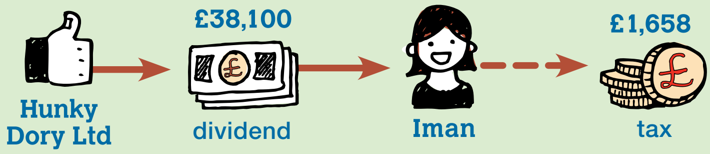
In 2015/16, Iman received a dividend of £38,100, which was effectively tax-free (since it was covered by her £10,600 personal allowance, with the remainder falling within her 10% dividend basic rate band). She had no other taxable income. Her husband typically receives a dividend of around £60,000 per year.



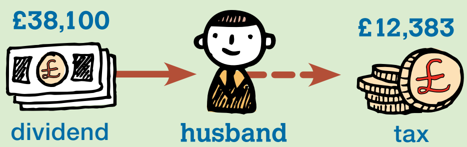
2016 / 2017

In 2016/17, Iman's tax liability on the same level of dividend would only be £1,658, calculated as shown here:

Spousal allowance	Basic rate
Cash dividend	£38,100
Less personal allowance	£(11,000)
Less dividend allowance	£(5,000)
Taxable dividend income	£22,100
£22,100 x 7.5%	£1,658



On the other hand, if her husband receives the £38,100 dividend instead, he would pay income tax on it of £12,383 (£38,100 x 32.5%).



of their children's further education. The dividend income can, of course, be applied by the child for any purpose or simply saved.

Readers will be aware that this strategy does not work for minor children (ie, those under the age of 18 and unmarried). This is due to the 'parental settlement' legislation in s629 ITTOIA 2005, which ensures that parents cannot provide a tax effective transfer of income to their minor children.

BEHAVIOURAL RESPONSES

In some cases, the higher rates of dividend tax are likely to encourage owner managers to retain profits within their companies, particularly where they do not need the income for personal expenditure or saving.

Furthermore, since HMRC has no current plans to increase the 25% 'loans to participators' tax charge, some may be tempted to 'live' off overdrawn loan accounts. If an overdrawn director's loan account is not repaid within nine months of the balance sheet date, the 25% 'section 455' tax charge is paid by the company as opposed to the director/owner manager. Furthermore, assuming the loan is interest free, the owner manager's tax cost is around 1.2% to 1.35% – the beneficial loan charge is currently based on an interest rate of 3%.

Owner managers who are contemplating retirement in the short term should consider the benefits of retaining reserves in 'their' company, which could potentially enhance the amount payable on a subsequent purchase of their shares by the company.

Provided the amount paid for their shareholding represents market value, it should be possible for the owner manager to obtain the beneficial 10% entrepreneurs' relief capital gains tax (CGT) rate on their exit from the company via a purchase of own shares deal.

However, HMRC is currently considering proposals to deal with unacceptable 'money-boxing' of income within companies and we may well see some legislative changes to deal with this in the near future.

RETHINK REQUIRED

The new dividend rules introduce a major structural change in the tax system. Owner managers will need to re-appraise their income extraction strategies. Existing calculations and spreadsheets will need to be reworked to determine the most palatable strategy for them. Most owner managers will be 'losers' but as shown above, there are a number of 'acceptable' tax planning strategies that could help to alleviate the increased tax cost of paying proprietorial dividends.

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