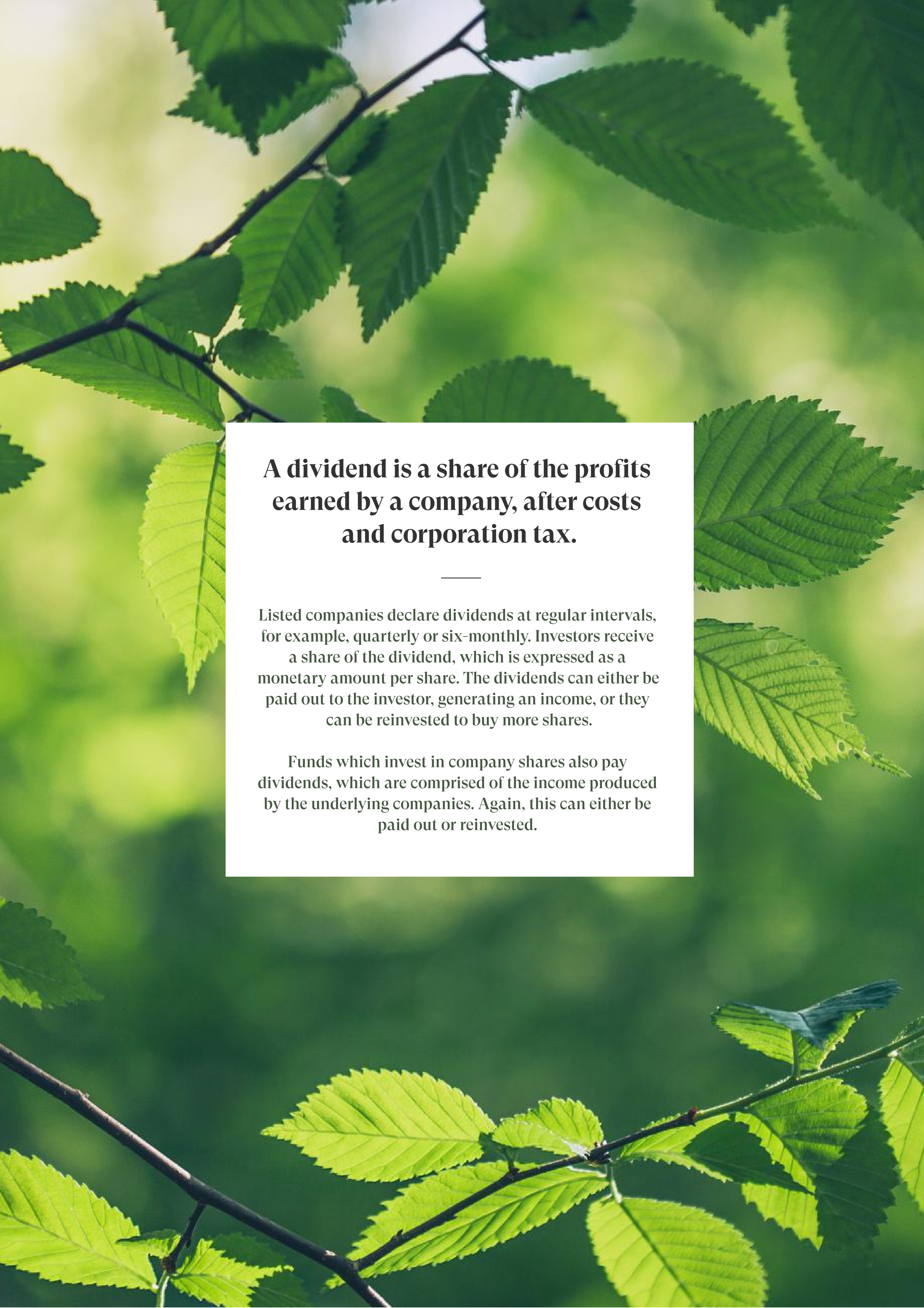
J EDWARD SELLARS INVESTMENTS

A Short Guide to Dividends and Tax



A dividend is a share of the profits earned by a company, after costs and corporation tax.

Listed companies declare dividends at regular intervals, for example, quarterly or six-monthly. Investors receive a share of the dividend, which is expressed as a monetary amount per share. The dividends can either be paid out to the investor, generating an income, or they can be reinvested to buy more shares.

Funds which invest in company shares also pay dividends, which are comprised of the income produced by the underlying companies. Again, this can either be paid out or reinvested.

Large companies often reinvest money back into the business, or pay large bonuses to reward key employees. This will reduce the dividend, and therefore the income payable to shareholders. Companies can also suspend dividends if their profits are reduced. Relying on a portfolio of shares to produce enough income to support your lifestyle can be risky.

Taking dividends from your own limited company operates on similar principles, but you have more control over the process. You can choose to pay out the dividends or reinvest profit in the company.

Shareholders will normally receive a share of the dividends (and have voting rights) proportionate to their ownership, but you can keep some control of this by issuing different classes of shares.

Most business owners find the limited company structure is much more tax efficient than running a business as a sole trader or partnership.

HOW MUCH TAX WILL YOU PAY ON DIVIDEND INCOME?

For individuals, the rates of tax are as follows:

- The first £2,000 per year of dividend income is tax-free. This is in addition to your tax-free personal allowance of £12,570 p.a.
- Basic rate taxpayers pay 7.5% tax on their dividends.
- For higher rate taxpayers, the rate is 32.5%.
- Additional rate taxpayers pay 38.1%.

While these rates are lower than the tax charged on other types of income (20%, 40%, and 45% respectively), remember that the companies have already paid corporation tax of 19%, a figure which is increasing to up to 25% by 2023.

For discretionary trusts, the rates are:

- 7.5% on dividend income falling within the basic rate band, which is £1,000.
- 38.1% on the remainder.

SHARES OWNED BY COMPANIES

The rules are different when shares are owned by another company. Where Company A owns shares in Company B, the dividends will be free of tax when received by Company A.

Tax is then payable by the shareholders of Company A, either when they take dividends or sell their shares.

There are a number of reasons why a company may own the shares of another business. The companies may be connected, or it may be purely for investment purposes.

Family investment companies have grown in popularity in recent years as they offer a tax-efficient wrapper to hold shares and property, and to pass on wealth. These schemes are complex and require specialised tax advice.

WHAT ARE THE BENEFITS OF TAKING DIVIDENDS?

As the director of a limited company, you will have the option to take your income in the form of salary, dividends, or a combination of both.

The benefits of taking dividends are:

- No National Insurance contributions are payable on dividend income, either for the employer or the employee.
- This means that for every £1 of profit earned by the company, more money will end up in your hands if you take dividends rather than salary.
- Dividends are also more flexible and can be adapted depending on the company's performance, rather than continually adjusting monthly payroll.

WHAT ARE THE DOWNSIDES?

Of course, there are some disadvantages to taking dividends rather than salary:

- You do not build up any State Pension based on your dividend income.
- Dividend income is not considered to be 'relevant UK earnings.' This could limit the amount that you can personally pay into a pension. However, it does not affect the amount that the company can contribute on your behalf. Many directors find that employer contributions are more efficient.
- Proving your income, for example to arrange a mortgage, can be more onerous.

Of course, the best way to manage the pros and cons of dividends versus salary is to take a combination of both. Most directors take a small salary (for example, around £8,000) as this is enough to build up State Pension credits without actually paying National Insurance.

The balance of salary and dividends can be adjusted depending on the business profits and what you want to achieve.

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OUR TIPS FOR REDUCING YOUR TAX BILL

Whether you are a business owner, or simply want to manage your share portfolio efficiently, the following tips will help you reduce your tax bill:

- Contribute to your ISA, as all income and gains are free of tax. Listed shares or funds that you already own can be moved into your ISA, although you may need to pay a small amount of stamp duty.
- Make pension contributions. For a business owner, this can be one of the most effective ways of extracting profits from the company as it is an allowable expense. Personal contributions receive tax relief at source.
- Allocating shares between spouses can make use of both sets of income tax and dividend allowances.
- Be wary of breaching tax thresholds. If you are close to the higher or additional rate tax band, you may be able to reduce your taxable income by making pension contributions or increasing your company's expenditure on allowable items.
- If you are reliant on your investment portfolio to produce an income, consider capital as well as income. You may be able to take tax-efficient withdrawals by utilising your Capital Gains Tax exemption. The total return of an investment is more important than the income yield alone.
- Seek advice if you want to pass on wealth to the next generation. Trusts, business relief, investment companies, and pensions can all have a role to play.

Please do not hesitate to contact a member of the team to find out more about investments and tax planning.

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