

# Dividends and PAYE/NI – What you should know

***Please note that the following applies to all Limited Companies, no matter how small.***

The advantageous tax treatment of dividends has led many owner managed business to adopt a practice of paying a small salary in return for the director's services provided and a larger dividend income as a reward for the investment in the shares.

Dividends do not (normally) attract national insurance contributions and whilst tax is due it is not collectable via the PAYE system but via an entry on the recipient's self assessment tax return form..

This article seeks to address the following areas:

- The problem
- Why has the risk changed?
- What should you do?
- What are the likely consequences?
- Could there be a personal tax liability on the director?
- Solutions offered by Complete Accounts Limited
- More detail on the activity of H M Revenue and Customs in recent times.

## The problem

Over recent years there have been a number of attempts by H M Revenue and Customs (HMRC) to limit this practice (see later). Although HMRC have had limited success with small owner managed business, it is clear that this is a key target area and will become more so in the years to come. It is also apparent that HMRC will seek to go back over **previous years** when they discover that there has been a problem. However, if HMRC look at your records for a current year and they find correct procedures in place, it is unlikely they will revisit previous years.

Complete Accounts wish to be proactive in this important area and ensure that clients are not left exposed to a high risk of hidden taxes and penalties. At the same time, we wish to limit the costs of the administrative burden that reducing the risk brings.

It is important that directors and shareholders of small owner managed businesses read this article and consider carefully its contents. If you would like to discuss any aspect in more detail the please do not hesitate to contact Chris Allen on 01926 855800.

## Why has the risk changed?

The economic crisis means that the government needs to raise more money without the politically undesirable option of raising tax rates. One option open to them is to raise money from fines and penalties on a reinterpretation or tightening up on the implementation of existing rules, alongside the introduction of new rules.

The actual process of finding problem areas is fast becoming automated.

- Tagging (iXBRL) – it is now compulsory for all Limited Companies to send full accounts to HMRC which are tagged. This is an electronic process by which the information on the accounts is picked up automatically by a computer. This means that the computer can carry out a comparison between the information provided and the information it would expect to see for the type of company is question. It can also compare the information with other items of information collected on the company.
- RTI – The system used from April 2013 which will enable all payments for wages to be picked up by the HMRC computer on a payment by payment basis.

It would not be rocket science, even for the government, to make a comparison between how much of the company profits are paid out to the directors as salary compared to that paid out as dividends.

## What should you do?

- ***Be careful what you call payments to yourself from the company. Distinguish between a payment of a dividend, salary or a loan***

Make sure that a dividend payment is covered by the following:

- It is properly authorised

The authority to pay or recommend dividends comes from the company's Articles of Association. These should be checked to be 100% sure but most will authorise the directors to pay interim dividends and recommend final dividends to the shareholders for approval.

- The individual authorising or paying a dividend needs to make sure that they have considered whether the company has sufficient reserves to pay the dividend at the time the payment is proposed. In essence, this means that there must be enough after tax profits retained in the company. Contact Chris Allen on 01926 855800 for a summary of how to do this.
- Paperwork is prepared to support the dividend (minutes of meetings, written resolutions for final dividends, dividend vouchers and waiver deeds where applicable).
- If you are paying a dividend and some of the dividend is being waived by the higher rate tax payer so that it falls mainly into the hands of a lower rate tax payer, extra care is needed. Contact Chris Allen on 01926 855800 for more details.

## What are the possible consequences?

The main consequence is that HMRC could argue that the payments for dividends are not actually dividends but are in fact payments for either:

- Salary in return for services provided

Or

- The dividends were unlawful as they did not comply with the provisions of the Companies Act 2006. In these circumstances, they are likely to be treated as a loan.

Note: Where there are loans from the company to directors (or shareholders) then there are tax consequences that arise from this.

If HMRC took this approach then you would need to defend your position. ***What you do now will have a bearing on how easy it is to do this.***

## Could there be a possible liability on the director personally?

In theory there could well be a personal liability in the following circumstances:

- If HMRC successfully argued that the payments were remuneration then they are taxable on the individual as such and would need to go on the personal tax return. The fact that the company had not deducted tax at source is only part of the problem. From the director's point of view, these would only be payments on account of the eventual liability. The tax and NI liability could ultimately be a personal one **as well** as a company one.
- If HMRC argues that the dividend payment was unlawful then it would be repayable to the company by the director. If there are unpaid taxes then, HMRC are a creditor and as such gain certain rights. In extreme cases, they could get the company to pursue the director or shareholder for repayment of the money so they could recover the unpaid tax.
- There are occasions when HMRC can issue a Personal Liability Notice ( PLN ) on a director – this is where they pursue a director through the courts for what was originally a company debt.

There are also the issues of the director's activities in this area falling short of the obligations imposed by the Companies Act but it is less likely these issues would come into play.

## Solutions offered by Complete Accounts Limited

The safe option is to ensure that the dividend payments are made in accordance with the Companies Act 2006. Complete Accounts offer a chargeable option whereby we would prepare the documentation for you. These are summarised as follows:

### Dividend paperwork / reserves review

Option	Detail	Note	Cost
1	Operate DIY - in house - you prepare - using my spreadsheet called "Dividend Manager – v March 2013"	I will provide the spreadsheet. You will have to consider available reserves, enter the detail and date and amount for the dividends paid. The system will then automatically provide minutes, shareholder resolutions, waiver documents and tax vouchers for you to print and sign. You are able to reprint historical minutes / vouchers if necessary and you have a summary for your tax return.	£75 one off set up.  Monthly fee of £10 to use the system.  Unlimited dividends
1a		<b><u>Please note the above is only available when there is a single class of shares</u></b>	
2	We prepare	<p>You let me know each time a dividend is required and I will check distributable reserves from available information and prepare the documents and return by e mail.</p> <p>Note: For this to have maximum effectiveness, you will need to have your records updated at least quarterly. In many cases, this is achieved by e mailing a bank download and copy sales invoices.</p> <p>If you maintain your own accounts, you will need to mail a report and there will be extra costs.</p>	<p>£75 one off set up</p> <p>£150 per year to cover 12 dividends.</p> <p>Additional dividends charged at £10 each dividend.</p> <p>Please note that the above costs apply when there is a single class of shares. Extra costs apply when more than one class of share exists.</p>

## In summary

It is clear that if and when any dividends are paid it is essential that the relevant Companies Act procedures are followed in connection with the passing of the appropriate resolutions, ensuring that the necessary company reserves are in place and the issuing of appropriate dividend vouchers at the right time. Failure to pay a dividend in accordance with these Companies Act requirements may simply mean that such a dividend has not in fact been paid which may leave open the way for HMRC to argue that any funds withdrawn on account of such a purported dividend are either remuneration or some sort of taxable loan. In addition there is also a requirement to comply with National Minimum Wage legislation. Whilst there is an exemption for office holders, i.e. directors who are not also employees, utilising this exemption will prejudice certain entitlements only available to employees, e.g. redundancy payments and certain tax credits dependent upon the claimant being employed.

In view of the overall position, owner managed businesses need to consider whether the continued payment of very low salaries is appropriate and, if not, take appropriate action to increase salary payments with of course the resultant additional PAYE tax burden and National Insurance contribution liabilities. Alternatively such businesses need to be aware that their position may be challenged at some point in the future. Normal HM Revenue & Customs approach in such circumstances is to look at not only the current year but certainly the **previous three years** and possibly beyond and to seek not only any additional tax/National Insurance due but also late payment interest and possibly penalties.

## More detail on the activity of H M Revenue and Customs in recent times.

*This section is quite technical but the information is provided to help you to see the cause of the concerns.*

The main HMRC activities in this area are:

- The introduction of specific legislation for tax purposes in Finance (No.2) Act 2005 and the National Insurance Contributions Act 2006 which now explicitly permits changes in the PAYE/National Insurance contribution regulations to be introduced on a retrospective basis back to 2 December 2004. In this respect it should be appreciated that certain backdated changes have already been made, albeit applicable only to very unusual and complex avoidance situations.
- The comment in the Economic and Fiscal Strategy report accompanying the 2007 Budget press releases that "The government will continue to monitor the level and extent to which labour income is extracted in dividends".
- The changes to the rules included in Finance Act 2007 in respect of managed service (composite/umbrella) companies which from 6 April 2007 are designed to force this particular type of structure to pay out profits as remuneration.
- The so called IR35 regulations which attempt to force certain companies to pay out all profits as remuneration. The Budget 2011 confirmed that these regulations are to continue despite recommendations to the contrary by the Office for Tax Simplification. Indeed the December 2012 Autumn statement announced legislation (probably from April 2013) to put beyond any doubt that individuals holding certain positions (in particular directorships and other similar senior positions) within their client's organisation are subject to IR35.
- The Arctic Systems case which challenged the payment of dividends to non working spouses in respect of certain types of company although, on this occasion, the taxpayers were successful in the courts.
- The case of P.A. Holdings Limited and another v HMRC (originally a Tax Tribunal decision released in 2009 but confirmed by The Court of Appeal in late 2011 and currently subject to an appeal to the Supreme Court expected to be heard in mid 2013) in which it was found that a PAYE and National Insurance charge could apply to dividends which were in reality received as a reward for employment services rendered and the 2010 Tax Tribunal case of Uniplex (UK) Limited in which an attempt to convert remuneration into dividends was overwhelmingly held to be ineffective (mainly because the relevant paperwork was either absent or defective).

- Anti-avoidance legislation included in Finance Act 2011 in respect of the use of Employee Benefit Trusts and the like (principally aimed at preventing tax avoidance but also seeking to impose National Insurance contributions on certain arrangements).
- The 2012 Tribunal case of Vardy Properties Limited in which a Stamp Duty Land Tax scheme was unsuccessful because a purported dividend was held to be invalid as there had been a failure to follow the appropriate Companies Act procedures.

In addition to the above there is considerable legislation introduced via Finance Act 2003 and Finance (No.2) Act 2005 which is directed towards countering complex tax avoidance schemes. However, in amongst this legislation have been changes to Section 447 Income Tax Earnings and Pensions Act 2003 which, with effect from 2 December 2004, reads as follows:-

***“447 Charge on other chargeable benefits from securities***

- (1) *This Chapter applies if an associated person receives a benefit [in connection with employment-related securities]*
- (2) *The taxable amount determined under Section 448 counts as employment income of the employee for the relevant tax year.*
- (3) *The “relevant tax year” is the tax year in which the benefit is received.*
- (4) *If the benefit is otherwise chargeable to income tax this section does not apply unless something has been done which affects the employment-related securities as part of a scheme or arrangement the main purpose (or one of the main purposes) of which is the avoidance of tax or national insurance contributions”.*

**NB** Associated person means (broadly) the shareholder and other connected persons. Sub-section 5 (not reproduced) is of no practical relevance

Late in 2006 HMRC issued further guidance as to their interpretation of the above provisions. This interpretation repeated a ministerial statement previously made in the House of Commons by Dawn Primarolo who said:-

*“I want to make clear that this change does not bring all benefits derived from securities into a tax and National Insurance charge. A reference to benefits in the context of the schedule means the employment reward – the passing of value to an employee in return for the employee’s labour. Where investors are carrying out their normal investment transaction, this charge will not affect them.”*

The guidance goes on to say that the legislation is directed towards complex contrived arrangements to avoid tax and national insurance contributions, in particular the use of special purpose vehicles, the use of managed service/composite companies (notwithstanding further legislation applicable to such companies effective 6 April 2007, as previously detailed) and the use of alphabet shares ( “b” or “c” shares ) with little value or rights being used to pay dividends to a range of employees. The ministerial statement also included a comment that *“this measure will not affect the taxation of those small businesses that do not use contrived schemes to disguise remuneration to avoid tax and National Insurance”.*

The issue is that there is uncertainty as to what “contrived schemes” are and what is acceptable. To date there does not appear to have been any specific attempt to challenge the position of owner managers who hold ordinary shares in a company and draw a low level of remuneration (sometimes perhaps only £8,000 per annum or so) with the balance of any profits being paid to the same people as a dividend in their capacity as shareholders. **However it may be that at some point in the future** HMRC will contend that the “fair” and “correct” amount of tax, where there is *“the passing of value in respect of the employment reward”* on the payment of a dividend to owner managers, is that due via PAYE with associated National Insurance contributions. If this occurs there may be doubt as to how easy it will be to defend the position of a director employee working (full time) for a very low salary especially following the Court of Appeal decision detailed previously in respect of PA Holdings Limited if this is upheld later this year by the Supreme Court.

## Disclaimer

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