

Dividends and PAYE/NI

You are no doubt aware of the potential advantages relative to the payment of dividends by your company to its director/shareholders. In particular dividends do not 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 with no further tax liability arising where the recipient is only liable to tax at the basic rate (broadly total income, including any dividends received, up to about £40,000 per annum).

You may also be aware that over recent years there have been various attempts to limit the use of dividends, in particular the following:-

- The so called IR35 regulations which attempt to force certain companies to pay out all profits as remuneration.
- The Arctic Systems case (final hearing due to be heard in the House of Lords in early June 2007) which challenges the payment of dividends to non-working spouses in respect of certain types of companies.
- The proposed changes to the rules 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 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 Budget announcement that the small companies corporation tax rate is to increase from 19% to 22% (to be partially offset by increased capital allowances on expenditure up to £50,000 for what were described as "genuine" small businesses) to combat the "abuse of incorporations" taking place for tax purposes (Gordon Brown speaking on Radio 5 on 22 March 2007) and the comment in the 2007 Economic and Fiscal Strategy report accompanying the Budget press releases that "The government will continue to monitor the level and extent to which labour income is extracted in dividends".

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 now 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 last year HM Revenue & Customs 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 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 are and what are not "contrived schemes" and what is and what is not 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 £5,000 per annum or so) with the balance of any profits being paid to the same people as a dividend in their capacity as a shareholder. However it may be that at some point in the future HM Revenue 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.

Following on from the above 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 HM Revenue & Customs to argue that any funds withdrawn on account of such a purported dividend are either remuneration or some sort of taxable loan.

Furthermore 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 five years and possibly beyond and to seek not only any additional tax/National Insurance due but also late payment interest and possibly penalties.