Understanding Dividends

Dividends are probably one of the most misunderstood aspects of running a private company. This article attempts to shed some light.

There are several key things to understand:

- Dividends are payable to shareholders, not to directors - although these may be the same person.
- Dividends are payable out of post-Corporation Tax profits. This means that, in particular for interim dividends (see below), it is necessary to calculate profit to date, and make an allowance for Corporation Tax, before the amount available for dividend is known.
- If dividends are paid without sufficient profit being available, they will generally be treated as loans from the company, with possible unfortunate consequences. (For example, if a loan to a shareholder is outstanding when Corporation Tax becomes due, 9 months and one day after the year end, then 25% “S419” tax must be paid. Although this can be repaid to the company after the loan is repaid, it is obviously desirable to avoid this charge.)
- This profit may be from the current year, or from previous years. It is the amount of accumulated profit which is relevant.
- Dividends must be properly declared and voted, either by directors or by shareholders, as appropriate, and a dividend voucher must be given to the shareholders as evidence of the dividend and associated tax credit.
- Dividends may be “interim” or “final”. Interim dividends are paid during the company year; final dividends after the year end.
- Interim dividends are *declared* by directors, without reference to shareholders; final dividends are *proposed* by directors, and *voted* by shareholders.

<u>Income Tax</u>
Dividends are paid with a notional tax credit of 1/9 of the amount *actually received* by the shareholder. For example, if a dividend of £900 is paid to a shareholder, there is a tax credit of £100. This notional amount is added to the £900, so that the shareholder’s *taxable income* is £1,000.

For basic rate taxpayers, the rate of tax on dividends is 10%, and this is deemed to have been satisfied by the tax credit[i].

Income	£1,000
Tax thereon	£ 100

Tax credit £ 100

Tax payable £ 0

For higher rate taxpayers, the rate of tax on dividends is 32.5%, of which 10% is satisfied by the tax credit.

Income	£1,000
Tax	£ 325
Tax credit	£ 100

Tax payable £ 225

£225 is of course 25% of the £900 actually received by the taxpayer. This is why one may hear the rate of tax on dividends described as 0%, 10%, 22.5%, 25% or 32.5%, all of which are correct in their own way.

[i] If any part of the dividend falls within the taxpayer's basic rate band (£6,035 in 2008-9) – ie they do not have earned or savings income which makes full use of the basic rate band – that part of the tax credit is not effective. Eg Dividend Income £10,000, and there is no other income; tax thereon, and tax credit is £1,000; however, only the amount above the basic rate band is "repayable". Therefore tax credit of £603.50 is not available to offset the tax.