Barristers & Incorporation Dividend Update

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Changes in the Taxation of Dividends

On July 8th during the budget speech, The Chancellor announced major changes to the taxation of dividends. These changes are to be implemented from April 2016. During the speech the Chancellor also mentioned addressing 'imbalances'. From the changes in dividends, it appears that one of those imbalances he seeks to address, is taxation of small companies.

It appears that the changes regarding dividend tax is another step in a process set to reduce the tax advantages of incorporation. Following on from the announcement in December 2014 were entrepreneurs' relief would be denied for disposal of goodwill to related companies. These changes seem to have the effect of discouraging individuals from incorporating solely to obtain a tax advantage.

From the budget speech the main changes, with regards to the taxation of dividends are as follows:

- A dividend tax free allowance of £5,000 (reducing to £2,000 from April 2017)
- The abolition of the dividend tax credit.
- According to the recently issued dividend fact sheet by HMRC a simpler system.

It is true that for many investors, with less that £5,000 of dividend income, the system is a lot simpler and may produce a tax saving. However, this is a bombshell for owner managed companies and the implementation of the new rules are quite complex. Those operating through a limited company should expect a larger tax liability from April 2016.

Once you are passed the £5,000 dividend tax allowance you then have the tax rates for the varying tax brackets as follows:

- Basic Rate – 7.5% (Previously 0%)
- Higher Rate – 32.5% (Previously 25%)
- Additional Rate – 38.1% (Previously 30.55%)

Is there more changes on the horizon with regards to reducing the tax advantage of incorporation? Please see below a brief extract from The Budget Red Book 1.189:

*"These changes will also **start to reduce the incentive** to incorporate and remunerate through dividends rather than through wages to reduce tax liabilities."*

If one was to take a cynical view, it could be interpreted that the bold text above was a hint that there may be future changes to align the 'imbalance' of remunerating through dividends as opposed to salary.

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Tax Consequences

Without going into the finer details, the calculation below are based on our interpretation of the changes as they currently stand.

The tables below demonstrate the following:

- Table 1 - the difference in tax liability between a self-employed individual and a limited company in the 2015/16 tax year.
- Table 2 - the difference in tax liabilities between a self-employed individual and a limited company taking into account the changes to taxation of dividends from April 2016.
- Table 3 – the difference between the tax liability of a limited company under the current legislation (Table 1) and new legislation from April 2016 (Table 2).

It has been calculated on under the following assumptions:

- Current 2015/16 personal allowance and tax band limits and rates are being implemented for both scenarios.
- The Limited Company figures assume the taxpayer has taken the most aggressive view about distribution of profits through a salary dividend split. (£10,600 for £100,000 and below, £8,060 £100,000+).
- The Company is a one person company.
- There are no other sources of income other than salary and dividends.
- All profits will be extracted from the company in the current tax period. Negating the tax planning benefits available to a limited company. Essentially giving a worst case scenario for the company figures.
- Excludes any other differentials between a company and sole trader. Such as, differences in treatment of cars. The additional cost of the admin burden and accounting fees associated with a company.

Table 1 -Current Situation:

Profit	Tax due Self-Employed	Tax due Limited Company	Tax Saving
£ 50,000	£ 12,790	£ 8,913	£ 3,877
£ 100,000	£ 33,790	£ 28,913	£ 4,877
£ 150,000	£ 59,030	£ 53,050	£ 5,980
£ 250,000	£ 106,030	£ 96,706	£ 9,324
£ 500,000	£ 223,530	£ 207,817	£ 15,713
£ 750,000	£ 341,030	£ 318,928	£ 22,102
£ 1,000,000	£ 458,530	£ 430,039	£ 28,491

Table 2 – New taxation of dividends:

Profit	Tax due Self-Employed	Tax due Limited Company	Tax Saving/(loss)
£ 50,000	£ 12,790	£ 10,174	£ 2,616
£ 100,000	£ 33,790	£ 31,858	£ 1,932
£ 150,000	£ 59,030	£ 56,508	£ 2,523
£ 250,000	£ 106,030	£ 104,524	£ 1,506
£ 500,000	£ 223,530	£ 230,724	(£ 7,194)
£ 750,000	£ 341,030	£ 356,924	(£ 15,894)
£ 1,000,000	£ 458,530	£ 483,124	(£ 24,594)

It is important to note that the above figures for taxation of a limited company are based on our interpretation of the changes to the taxation of dividends.

Table 3 – Difference between old and new taxation of dividends:

Profit	Tax due Limited Company Currently	Tax due Limited Company New Div Rules	Tax Saving/(loss)
£ 50,000	£ 8,913	£ 10,174	(£ 1,261)
£ 100,000	£ 28,913	£ 31,858	(£ 2,945)
£ 150,000	£ 53,050	£ 56,508	(£ 3,458)
£ 250,000	£ 96,706	£ 104,524	(£ 7,819)
£ 500,000	£ 207,817	£ 230,724	(£ 22,907)
£ 750,000	£ 318,928	£ 356,924	(£ 37,996)
£ 1,000,000	£ 430,039	£ 483,124	(£ 53,085)

Points for the Future

The figures above are based on how things currently stand. However there are a few changes, which are widely anticipated, to happen in the near future. Including the following:

- Class 2 NI – Set to be abolished
- Class 4 NI – With the abolition of Class 2 NI it is expected that Class 4 NI will increase from 9% to 12% to being it in line with Employees Class 1 NI. This will result in a higher tax liability for self-employed individuals.
- Corporation Tax – is expected to drop by one percent in 2017 to 19% and then a further one percent before 2020 to 18%. This will result in a tax saving for those opting towards incorporation.

Other Points to consider:

The above figures do not take into account the benefits of having a lay person (E.g. Non-earning spouse) as a shareholder. This option would produce a further tax advantage for incorporation.

There are also other minor tax advantages available when trading as a limited company such as:

- Tax planning opportunities – you can choose the amount you withdraw from the company avoiding higher rates bands where possible.
- Directors Loan Accounts – potential to make use of the £2,000 saving income nil rate band recently introduced.

Summary

In what seems like a cruel twist of fate, after years of consultation regarding Barristers and Incorporation. 6 months after the Bar Council allow Barristers to incorporation the Government implement changes that will drastically reduce the benefit, from a purely tax perspective, of incorporating.

If you were considering incorporating mainly due to the tax advantages, then I may reconsider. It may be worthwhile postponing any plans with regards to incorporation, until the position regarding dividends is clear, especially taking into account the benefits are only marginal.

The majority of any tax advantage will no longer be available after April 2016. However the more stringent recording keeping requirements, red tape, compliance and larger admin burden will remain.