Clemence Hoar Cummings
Chartered Accountants

Guide to Dividend Tax

New regulations brought in on 6th April 2016, have resulted in substantial changes to the way in which tax is applied to dividends.

This means that company owners who receive dividend income could see significant tax rises.

Our guidance is designed to give a general overview of the key changes. However, in order to get expert advice that is tailored to meet your specific needs, please contact us.

How dividend income was previously taxed…

Net dividends (the amount paid to an individual) were multiplied by 10/9 to produce the gross dividend amount, which was then taxed as follows:

- 10 per cent (basic rate)
- 32.5 per cent (higher rate)
- 37.5 per cent (additional rate)

However, once the applicable tax rate was paid, no further tax was owed on dividends falling into the basic rate tax band while 25 per cent was owed on dividends in the higher rate band, and 30.56 per cent on those in the additional rate tax band, when compared to a traditional salary payment large savings were made.

For example, in the last tax year (2015/16), an individual was able to earn £31,785 in gross dividends (equivalent to £28,606.50 in net dividends), as well as benefiting from the £10,600 personal allowance. This meant that, in total, £42,385 was earned without being liable for any income tax.


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What changes have been made?

The Government has decided to implement changes to the way dividend tax operates. The new rules have put an end to some of the tax benefits that individuals receive by operating through a limited company instead of being paid as an employee.

The previous tax credits system was abolished and on 6th April 2016, a new £5,000 tax-free allowance was introduced. This means that an individual can earn £5,000 in dividend income but anything over that amount is liable for tax, regardless of other earnings.

The personal allowance (the amount that can be earned before tax is applied) from 6th April 2016 is £11,000. If someone is entitled to the full allowance and also earns £5,000 of dividend income, they will earn £16,000 and not have to pay any dividend tax.

For dividend income that exceeds the £5,000 annual allowance, tax will be applied to any additional amount as follows:

- 7.5 per cent (basic rate)
- 32.5 per cent (higher rate)
- 38.1 per cent (additional rate)

The table below reviews the total tax costs of paying dividends out of a company in 2016/17 compared with 2015/16 (this table does not take into account the £5,000 tax-free dividend allowance). Significant increases in the effective dividend tax rates can be seen under the new system.

	Basic rate taxpayer	Higher rate taxpayer	Additional rate taxpayer
Company profits	£100	£100	£100
Corporation tax at 20 per cent	(£20)	(£20)	(£20)
Post-tax profits	£80	£80	£80
Dividend tax at 7.5 per cent/ 32.5 per cent / 38.1 per cent	(£6)	(£26)	(£30.50)
Shareholder’s income	£74	£54	£49.50
Effective tax rate 2016/17	26 per cent	46 per cent	50.5 per cent
Effective tax rate 2015/16	20 per cent	40 per cent	45 per cent

Basic rate taxpayers with dividends... beware

Anybody who is in receipt of dividend income in excess of £5,000 per annum who is currently a basic rate taxpayer and is not currently required to complete a tax return will need to do so for the 2016/17 year.

Should I be taking a salary instead of a dividend out of my company?

As a result of the changes, SME owners may need to rethink the way they pay themselves.

On the face of it the tax liabilities for higher rate and additional rate taxpayers would seem to point towards extracting a salary rather than using the dividend route, however when both Employers' and Employees' National Insurance contributions are taken into account then there are still advantages to using the low salary / high dividend option where this is available. In each of the examples below the cost to the company is the same but there is a difference in the amount the individual receives net of tax and NI.

	High Salary / Low Dividend		Low Salary / High Dividend	
	Individual	Company	Individual	Company
Basic Rate Taxpayer				
Salary	43,000	43,000	8,060	8,060
Employers' N.I.		4,822		
Dividend	5,000	5,000	36,809	36,809
Income Tax	(6,400)		(2,632)	
Employees' N.I.	(4,193)			
Corporation Tax		1,250		9,203
Net Income	37,407		42,237	
Cost to Company		54,072		54,072

	High Salary / Low Dividend		Low Salary / High Dividend	
	Individual	Company	Individual	Company
Higher Rate Taxpayer				
Salary	95,000	95,000	8,060	8,060
Employers' N.I.		11,998		
Dividend	5,000	5,000	84,150	84,150
Income Tax	(27,200)		(18,018)	
Employees' N.I.	(5,233)			
Corporation Tax		1,250		21,038
Net Income	67,567		74,192	
Cost to Company		113,248		113,248

	High Salary / Low Dividend		Low Salary / High Dividend	
	Individual	Company	Individual	Company
Additional Rate Taxpayer				
Salary	195,000	195,000	8,060	8,060
Employers' N.I.		25,798		
Dividend	5,000	5,000	175,190	175,190
Income Tax	(73,850)		(54,051)	
Employees' N.I.	(7,233)			
Corporation Tax		1,250		43,798
Net Income	118,917		129,199	
Cost to Company		227,048		227,048

For those over the state retirement age this advantage will be less marked, and it depends on the level of overall income.

There are other factors to consider when opting for the dividend route for example in relation to potential mortgage applications and also pension contributions and so in summary the answer to the question; Should I be taking a salary instead of a dividend, is that it all depends, everyone has unique circumstances and you should seek guidance from your engagement partner at Clemence Hoar Cummings.

Who benefits from the changes?

Dividends remain a tax-efficient option for basic rate taxpayers.

Sole traders usually choose the incorporation route in order to reduce their personal tax liability by taking dividends combined with a smaller salary. Even now, this group could still find that incorporation is beneficial, depending on their individual circumstances.

CLEMENCE HOAR CUMMINGS
CHARTERED ACCOUNTANTS

Clemence Hoar Cummings
1 - 5 Como Street,
Romford,
Essex RM7 7DN

T: 01708 333300

E: info@chc.uk.com

W: www.chc.uk.com