Factsheet from

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Helping smaller businesses and their owners manage their accounting and taxation affairs

A Guide to the Summer Budget 2015

The New Dividend Tax

A SIMPLE GUIDE TO THE NEW DIVIDEND TAX INTRODUCED IN THE SUMMER BUDGET 2015

The chancellor George Osborne gave his Summer Budget report on 8 July 2015. It was certainly not a budget for smaller businesses. A key change for many small incorporated businesses is the introduction of a new dividend tax. The matters need to be enacted to become law and most probably included in the Finance Bill 2016.

The new tax on dividend income from 6 April 2016

The Government will abolish the Dividend Tax Credit from April 2016 and introduce a new Dividend Allowance of £5,000 a year. The new rates of tax on dividend income above the allowance will be 7.5% for basic rate taxpayers, 32.5% for higher rate taxpayers and 38.1% for additional rate taxpayers.

The changes appear to be aimed at small limited companies that pay a small salary designed to preserve entitlement to the State Pension, together with a much larger dividend payment in order to reduce National Insurance costs.

There will be some significant extra costs to many small owner-managed businesses that trade through a limited company.

Typical remuneration policy

Most owners of small limited companies draw a small salary, of around £8,000 to £10,000 pa, to use up their personal allowance, and then take their excess drawings through dividends. Currently, any director-shareholder that draws a combined salary and dividend of up to around £42,000 pays no personal tax on their salary or dividends.

The position now

Currently, when a cash dividend is taken by a shareholder, the dividend is grossed up by adding a tax credit of 1/9th of the cash dividend. So, a cash dividend of £9,000 has a taxable income value of £10,000. A basic rate taxpayer will pay a 10% tax rate on the £10,000 dividend which is covered by the £1,000 tax credit, so no net tax is actually payable.

When a higher rate tax payer receives a grossed up dividend of £10,000, they pay 32.5% on that dividend i.e. £3,250. They can then deduct the £1,000 tax credit and actually have to pay £2,250 in extra income tax. Putting it another way, a higher rate tax payer currently pays 25% of the net cash dividend. i.e. 2,250 / 9,000 = 25%.

What is changing?

From 6 April 2016, these director-shareholders will pay an extra tax of 7.5% on all their dividends above £5,000. This will therefore mean that around £2,000 of extra income tax will be payable by any business owner-shareholder, with company profits of £47,000 pa, who was just hitting the higher rate tax band, by taking £8,000 pa salary and then taking the rest of their profits by dividend.

There is still much uncertainly by many taxpayers exactly how the new dividend tax rule will work in practice. We will try to explain the current and new system below.

From 6 April 2016, the concept of net and gross dividends will disappear. A tax payer will either pay 7.5% (for a basic rate tax payer) or 32.5% (for a higher rate tax payer) on any cash dividends they receive over £5,000 pa. A higher rate tax payer will still pay the 7.5% rate on that part of their dividends that fall within the basic rate band.

This has some strange consequences. A higher rate tax payer would currently pay £2,500 income tax on a £10,000 cash dividend and a basic rate tax payer would pay nothing. From 6 April 2016, a higher rate tax payer will pay £1,625 in tax and a basic rate tax payer £375. So, a higher rate tax payer could be better off from 6 April 2016. They will now pay an extra 7.5%, increasing the rate from 25% to 32.5% of the (net) cash dividend. Do not confuse the old 32.5% tax on grossed-up dividends (with the 10% tax credit) with the new 32.5% tax payable on (non-grossed up) dividends.

What can you do to minimise the new dividend tax?

1. Take dividends sooner

   The new tax rules come into effect from 6 April 2016. So, if you can, consider taking dividends before 6 April 2016. However, don’t make the mistake of drawing too much in dividends that you enter another tax band e.g. paying an extra 25% in higher rate tax rather than paying an extra 7.5% as a basic rate tax payer.

2. Ensure you use the annual tax-free dividend allowance

   Each tax payer will be entitled to a new tax-free dividend allowance of £5,000 per annum. Couples could consider spreading their taxable dividends between them to make full use of each person's allowance.

3. Make the most of each spouse's income tax allowance and tax bands

   Couples should make full use of personal allowances and basic rate tax bands, where applicable, so that dividends are paid in the name of the spouse who pays the lowest tax rates.

4. Reduce other income

   The dividend tax is linked to the rate of income tax you pay. Therefore reducing other taxable income could also reduce the amount of dividend tax paid. In some cases taxable income for a particular year could be reduced, perhaps by transferring income bearing assets such as cash deposits to a lower earning spouse, or by deferring taking income until the next tax year e.g. by taking withdrawals from a drawdown pension until another tax year.