All Change on the Taxation of Dividend's

New Dividend Tax Proposals from April 2016

One of the biggest changes announced recently by George Osborne was how dividends are to be taxed from April 2016.

This change will have an effect on all small businesses, limited company freelancers, and contractors who use the low salary and dividend strategy of profit extraction.

The full details have yet to be disclosed but this is the current understanding on the changes.

How it currently works and will do up until April 2016

There is something called the dividend tax credit which means that any dividends you take out in the tax year that are in the lower tax band attract no personal tax and any dividends in the higher tax band are charged at 25% of the cash dividend (or 22.5% of the gross dividend).

The new way- from April 2016

There will be no more dividend tax credit.

Your first £5,000 of dividends will be tax free. Any taken dividends after that which are still in the basic tax band will be charged at 7.5% and any dividend in the higher tax band will be charged at 32.5%.

This means that in the higher tax band you will have an increased personal tax charge of 7.5%.

However in the lower tax band it is more complicated as you have the £5,000 of tax free dividends to factor in to the equation.

So What does this mean?

Example 1- Company director taking a low salary and dividends up to the higher tax band but no further (old way)

Based on the 2016/17 proposed tax rates (higher tax band at £43,000) and a simple monthly salary of £670 per month.(Up to the national insurance lower earnings threshold)

	Old Method 2016/17	**New Method 2016/17**
Company Profit Details		
Company Profit before salary	47,370	47,370
Salary	8,040	8,040
Company Profit	39,330	39,330
Corporation Tax – 20%	(7,866)	(7,866)
Maximum Cash Dividends	31,464	31,464
Director Tax Details		
Salary	8,040	8,040
Dividends	31,464	31,464
Total gross income	43,000	39,504
Tax on dividends @ 7.5%	**0**	**1,985**

By using the old method and taking salary and dividends up to the higher tax band would have incurred no personal tax but under the new method it incurs £1,985 of personal tax. *Calculated by taking the £31,464 cash dividends, less the £5,000 dividend allowance tax free amount = £26,464 x 7.5%.*

Example 2- Company Director taking a low salary and dividends up to the higher tax band but no further (new way) – Utilising the additional dividend due to the removal of the 10% tax credit.

The same as in example 1 but this time maximised the new scenario to the higher tax band.

	Old 2016/17	**New 2016/17**
Salary	8,040	8,040
Dividends	34,960	34,960
Total gross income	46,884	43,000
Tax on dividends	**874**	**2,247**

Meaning an additional £1,373 in personal tax. With the new method you will have to pay more personal tax than in the past but you will be able to extract a bit more dividend until you hit the higher tax band.

Example 3 – Company Director taking out low salary and dividends of £80k per year.

	Old 2016/17	**New 2016/17**
Company Profit Details		
Profit before salary	108,040	108,040
Salary	8,040	8,040
Profit	100,000	100,000
Corporation Tax – 20%	(20,000)	(20,000)
Max Cash Dividends	80,000	80,000
Director Tax Details		
Salary	8,040	8,040
Dividends	80,000	80,000
Total gross income	96,929	88,040
Tax on dividends	**12,134**	**16,885**

In this example it would mean an additional £4,751 in personal tax.

Note

If you have dividend income (dividends held outside of an ISA) of £5,000 or less per year you will pay no tax on your dividends, even if you are a higher rate taxpayer. Your dividends are covered by the £5,000 dividend allowance.

If your total income is less than £11,000 your income is covered by your personal allowance and yor dividend allowance is effectively unused.

If your dividend income is received through shares in an ISA, as now, these remain tax-free and the dividend allowance will not affect this income.

How does this change things, what can be done?

This is likely to mean a few things:

- Switching from a sole trader to a limited company for tax savings is not as attractive. There are still tax savings but they aren't as big.
- If you have a spouse it is more important than ever to consider if there are income splitting opportunities (them being a shareholder and /or director so they can take a dividend and/or a salary).
- If you're not already you should consider company pension contributions.
- You may need to do a self-assessment for personal tax returns from April 2016, whereas before you had no taxable income.
- It could be worth taking a one off larger dividend before the end of the 15-16 tax year.