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Dividend taxation for 2016/17

The new dividend tax regime came into effect from 6 April 2016. Gone is the dividend tax credit and in its place a new dividend allowance for all taxpayers. There are also changes to the dividend tax rates.

The abolition of the tax credit simplifies taxation of dividends in that it is no longer necessary to perform a grossing up calculation to arrive at the amount of taxable dividend income – the amount received is now the taxable amount. However, there is no tax credit to set against the tax liability either.

Dividend allowance

All taxpayers, regardless of their marginal rate of tax, receive a dividend allowance of £5,000. This is not an `allowance' in the true sense of the word, but rather a nil rate band which applies to the first £5,000 of taxable dividend income. Dividends which fall within this band are taxed at a zero rate, so are received tax-free.

However, the £5,000 `allowance' uses up part of the taxpayer's basic or higher rate band, as appropriate, as dividends falling within this band are counted as taxable income (albeit taxable at a zero rate).

Dividend rates

Once the dividend allowance (and any available personal allowances) have been used up, dividends are treated as the top slice of income and are taxed at the appropriate dividend rate. The dividend rate is 7.5% to the extent that the dividends fall within the basic rate band (the ordinary dividend rate), 32.5% to the extent that they fall within the higher rate band (the dividend upper rate) and 38.1% to the extent that they fall within the additional rate band (the dividend additional rate).

Example

Penny has a salary of £20,000 and receives a dividend of £25,000 from her family company in 2016/17.

The salary is treated as the first slice of her income and uses up her personal allowance of £11,000 and the first £9,000 of her basic rate band. She pays tax of £1,800 on her salary (£9,000 @ 20%).

This leaves £23,000 of her basic rate band available (£32,000 - £9,000).

The first £5,000 of her dividend income is covered by her dividend allowance and taxed at the zero rate.

This leaves £18,000 of her basic rate band remaining (£23,000 - £5,000).

The next £18,000 of her dividends are taxed at the ordinary dividend rate of 7.5%, giving rise to a liability of £1,350,

The remaining £2,000 of dividend income is taxed at the upper dividend rate of 32.5%, giving rise to a tax liability of £650.

The tax payable on Penny's dividends is therefore £2,000 ((£5,000 @ 0%) + (£18,000 @ 7.5%) + (£2,000 @ 32.5%)).

Need to know

All taxpayers receive the dividend allowance regardless of the rate at which they pay tax. This should be taken into account when formulating a profit extraction strategy for your family company.

Partner note: Finance Bill 2016, cl. 5.

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