TURCAN CONNELL

Briefing Note

Dividend Tax from April 2016

As announced in the Chancellor's Summer Budget last year, the tax regime for dividends changed dramatically with effect from 6th April 2016. The changes will affect taxpayers in widely different ways, depending on the level of their dividend receipts and other income.

There are three elements to the changes:

- An increase in the effective tax rates for dividends by 7.5% across all tax bands. The new rates are 7.5% for a basic-rate taxpayer, 32.5% for a higher-rate taxpayer and 38.1% for an additional rate taxpayer. It should be noted that the former dividend rates of 10%, 32.5% and 37.5% gave effective rates of 0%, 25% and 30.6% respectively after taking account the notional dividend tax credit.
- The 10% dividend tax credit has been abolished, along with the need to "gross up" dividends. This is a welcome simplification, given that this tax credit was notional and could not be reclaimed by non-taxpayers.
- The introduction of a tax-free £5,000 dividend allowance which applies for all taxpayers, regardless of their income levels. The effect of this allowance is that the first £5,000 of dividends received by each individual are taxed at a rate of 0%, but are still included in the calculation of total taxable income.

It is worth noting that the abolition of the national tax credit will reduce a taxpayer's total income for tax purposes. Under the old rules receiving a dividend of £9,000 would have added £10,000 to total taxable income. This has implications where total income levels affect reliefs, allowances and tax charges – such as the personal allowance, the cap on Income Tax loss reliefs, child benefit tax charges and the pension annual allowance.

The table below provides a summary of the new rates and a general indication of the winners and losers:

	Effective tax rate before 6th April 2016	**Tax rate from 6th April 2016**	**Tax liability reduced where:**	**Tax liability increased where:**
Basic rate taxpayer (income over £11,000)	0%	7.5%	n/a	Dividends over £5,000
Higher rate taxpayer (income over £43,000)	25%	32.5%	Dividends less than £21,667	Dividends more than £21,667
Additional rate taxpayer (income over £150,000)	30.6%	38.1%	Dividends less than £25,250	Dividends more than £25,250

Investing for Capital vs Income Returns

The increase in dividend rates makes it sensible (from a tax viewpoint) to focus on capital returns rather than income when making investments. With the surprise reduction in the top rate of capital gains tax from 28% to 20% announced in the March 2016 Budget, this becomes even more important.

In 2015/16, a higher rate taxpayer was better off receiving dividends; these were taxed at an effective rate of 25%, as opposed to 28% for capital gains. In 2016/17, the increased 32.5% rate on dividends is significantly higher than the new 20% rate payable on capital gains.

For an additional rate taxpayer the balance is even more firmly in favour of capital returns (dividends being taxed at 38.1% as against gains at 20%.) For a basic-rate taxpayer, dividends remain slightly more attractive (7.5% for dividends, 10% for gains.)

This assumes that the dividend allowance, Capital Gains Tax annual exemption and ISA allowances are already fully used, and these should be the priority in managing investments tax efficiently.

Owner Managed Businesses

The new rules have major implications for those that operate a business through their own company. It will now be substantially more expensive to draw large sums from a company by way of dividend. This significantly reduces the tax benefits of incorporating a business.

For example, a sole trader with £50,000 of profits in 2016/17 will pay Income Tax of £9,200 and Class 4 NIC of £3,285, giving a total tax bill of £12,485.

If the same business was held in a company then under the old dividend rules, if the owner drew a salary of £8,000 and extracted the remainder as dividends, the total payable to HM Revenue and Customs is £8,925 (Corporation Tax of £8,400 and Income Tax of £525.)

However, under the new rules, the Income Tax bill will increase to £1,920, leading to an overall tax liability of £10,320 (Corporation Tax of £8,400 and Income Tax of £1,920). Given the additional administration requirements of a company, this makes it significantly less cost effective to incorporate than in the past. However, other factors continue to make companies attractive, such as the benefits of limited liability.

Trusts and Estates

The trust dividend tax rates are also increased by 7.5%. However, the dividend allowance is not available for trustees. Discretionary Trusts will pay the same rate as applies to additional rate taxpayers, now 38.1%.

Liferent trusts and Executries previously had no tax to pay on dividend income, but will now pay 7.5% Income Tax. The beneficiary will then be able to set the tax paid by the trustees/executors against their own tax liability, or reclaim it if this income is within their personal allowance or dividend allowance.

This briefing note is intended as a short summary of Dividend Tax from 6th April 2016. No responsibility can be accepted for any action taken in reliance on this note and specialist advice should be taken in every case. Turcan Connell would be happy to provide such advice.

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