New Dividend Tax Rules for 2016

George Osborne announced changes to the way in which income tax will be paid on dividends from April 2016. Although investors with relatively small amounts of dividend income will be removed from the scope of tax, this is clearly designed to raise taxes, predominately from shareholders extracting profits from owner managed companies (OMCs).

This briefing is based on information currently available and is designed to explain the changes and demonstrate the impact on some typical tax payers. Detailed legislation is awaited in Finance Bill 2016.

It is also worth noting that dividends were mentioned again at the Autumn Statement, and the Government intends to consult further on the rules concerning company distributions. This suggests that this is an area which will need to be kept under review.

What are the changes?

The proposed new rules will impact individuals, and probably trusts who pay income tax; companies will not be affected:-

- The 10% dividend tax credit will be abolished
- A new tax-free ‘dividend allowance’ of £5,000 per year will be introduced
- The effective rates of tax on dividend income will increase by approximately 7.5% to:-
  - 7.5% for basic rate tax payers (previously 0%)
  - 32.5% for higher rate tax payers (previously 25%)
  - 38.1% for additional rate tax payers (previously 30.6%)

What does this mean for you?

The changes represent a radical change to the way in which dividend income will be taxed. The exact effect on tax payers will depend on each person’s individual circumstances.

However, in general:-

- Basic rate taxpayers with dividends above £5,000 will be worse off;
- Basic rate taxpayers with dividends below £5,000 will see no change;
- All higher and additional rate taxpayers with dividends below £5,000 will be better off;
- Where non-dividend income is sufficient to make a taxpayer subject to higher rate (or additional rate) tax, the combination of the dividend exemption and changed rates means that a higher rate taxpayer with dividends up to £21,667 is likely to be better off (up to £25,232 for additional rate taxpayers);

- However, all those with significant dividends, and low income from other sources (such as those taking a low salary and high dividends out of an OMC) will be worse off; some significantly so. This is irrespective of whether they are basic, higher or additional rate taxpayers.

It will be important to examine each individual's circumstances to work out the exact effect of the new rules, particularly where income is close to the boundaries where higher rate and additional rate tax becomes payable, or personal allowances begin to be lost.

Some examples help to illustrate this (assuming a Personal Allowance of £11,000, and a Basic Rate Band of £32,000):-

1. Alfred has a pension of £15,000 per annum, and dividend income of £5,000. He is a basic rate tax payer. He will be unaffected by the new rules as all dividend income will be covered by the new dividend allowance.
   However, if dividend income was £10,000 in 2016, £5,000 above the dividend allowance will be taxed at 7.5% to give a tax liability of £375. If the 2015 rules continued to apply, the tax liability would be covered by the tax credit and there would be no further tax to pay.

2. Brian is a higher rate tax payer. He has a salary of £40,000 and he receives dividend income of another £40,000 in 2016. £3,000 of his dividend allowance is set against dividend income which would otherwise be taxed at basic rate, leaving £2,000 of the allowance set against his dividend income taxed at 32.5%. The remaining £35,000 of dividend income is taxed at the higher rate applicable to dividends of 32.5%. He has to pay £2,050 more tax than he would have done if the 2015 rules had applied.

3. Catherine is the owner and manger in a successful internet company. She has restricted her salary to a modest £11,000 and tops up her income with a dividend of £150,000. She will pay income tax at additional tax rates on the slice of her income above £150,000. Her £5,000 dividend allowance is set against that part of her dividend income taxed at basic rate (7.5% for dividends) leaving the remainder of her dividend income taxable at higher and additional rates. She will pay £9,583 more income tax under the new rules compared to the position if the 2015 rules applied.

Those with significant dividend incomes are consequently hit hardest by the new dividend tax rules, although many others will have higher tax bills in 2016 than they might have expected.

What can be done?

General investors may have little option other than to pay up or decide to pursue a different investment strategy. However, shareholders in OMCs may have more ability to plan their income levels.

OMCs might like to consider, for instance:-

- Low salary and high dividends are likely to remain a more effective tax strategy where feasible, but the tax saving will narrow;
- Dividends could potentially be accelerated into the 2015/16 tax year before rates go up, with future dividends being reduced accordingly. However, this needs considering case by case, as:-
    - Additional dividends might push your total income into a higher tax bracket;

    - You will need sufficient cash flow to pay the income tax due in January 2017, even if the dividend itself is not drawn in cash; and
    - The dividend must be declared properly, including ensuring there are sufficient distributable reserves available and that the paperwork is all completed correctly.
- Sharing income appropriately around the family (for instance, splitting company shares with a spouse, if carefully implemented, to take advantage of personal allowance / basic rate band);
- Flexing the level of income drawn year on year to improve the position;
- How the company should interact with your pensions planning;
- Tax efficient benefits in kind;
- Any different forms of profit extraction available.

If you are affected by the issues discussed in this briefing and would like more information concerning your own personal circumstances, please speak to your usual Ensors contact or the Ensors Corporate Tax team on 01473 220022. We would be pleased to advise on the impact of the changes for you, and in reviewing the overall profit extraction strategies for OMCs.