NEWBY CASTLEMAN
FORWARD THINKING ADVICE
CHARTERED ACCOUNTANTS
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WEST WALK BUILDING
110 REGENT ROAD
LEICESTER LE1 7LT
T: 0116 254 9262
F: 0116 247 0021
E: INFO@NEWBYC.CO.UK

ELTHAM HOUSE
6 FOREST ROAD
LOUGHBOROUGH LE11 3NP
T: 01509 263 500
F: 01509 234 811
E: LOUGH@NEWBYC.CO.UK

WWW.NEWBYCASTLEMAN.CO.UK

The new rules on dividends

April 2016 saw significant changes to the rules on the taxation of dividends, which could have a significant impact on the amount of tax you pay. This factsheet provides an overview of the new system, together with information and advice to help keep your tax bill to a minimum.

Rules prior to 6 April 2016

Prior to 6 April 2016, the taxation of dividends had been made complicated due to a 10% tax credit being added to the cash amount of the dividend, with the tax credit then satisfying all or part of the income tax liability on the dividend.

The practical effect of the system was that basic rate taxpayers had no further tax to pay on dividend income and a higher rate taxpayer paid an effective 25% on the cash amount of the dividend receipt. However, from 6 April 2016 this tax credit came to an end and dividend income is now taxed at new tax rates.

Changes from April 2016

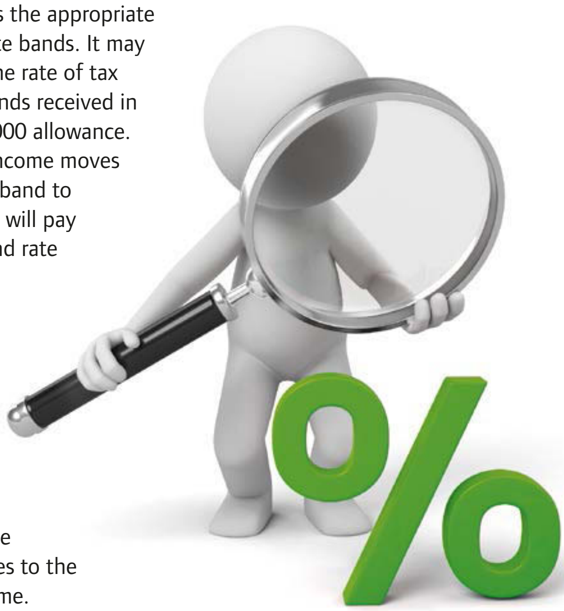
A new Dividend Allowance of £5,000 per annum has been introduced from the 2016/17 tax year. This is in addition to an individual's Personal Allowance. The Dividend Allowance does not change the amount of income that is brought into the income tax computation. Instead it charges £5,000 of the dividend income at 0% tax – the dividend nil rate. This means that:

- The payment of a low salary below the Personal Allowance will allow some dividends to escape tax as they are covered by the Personal Allowance.
- The £5,000 allowance effectively reduces the available basic rate band for the rest of the dividend.

Headline rates of dividend tax have also changed. From 6 April 2016 the rates of tax on dividends over £5,000 are:

- 7.5% on dividend income within the basic rate band (ordinary rate)
- 32.5% on dividend income within the higher rate band (upper rate)
- 38.1% on dividend income within the additional rate band (additional rate).

The Dividend Allowance will not reduce total income for tax purposes, and dividends within the allowance will still count towards the appropriate basic or higher rate bands. It may therefore affect the rate of tax payable on dividends received in excess of the £5,000 allowance. If your dividend income moves you from one tax band to another, then you will pay the higher dividend rate on that amount.



Example one

Here is an example showing the taxable amounts after allocating the relevant allowances to the two types of income.

	Non-dividend income (£)	Dividend income (£)
	18,000	**22,000**
Dividend Allowance	-	5,000
Personal Allowance	11,000	-
Taxable at basic rate	**7,000 (20%)**	**17,000 (7.5%)**

As total income is £40,000 and the amount at which higher rate tax starts to apply is £43,000, the dividend income above £5,000 is taxed at 7.5%.

Example two

This example is more complicated. Total income is £49,000 and thus some income falls into the higher rate band. Dividends are treated as being the top slice of income. The Dividend Allowance is split into two – £3,000 to use up the balance of the basic rate band and £2,000 to 'eat into' the higher rate band.

	Non-dividend income (£)	Dividend income (£)
	40,000	**9,000**
Personal Allowance	11,000	-
Dividend Allowance to basic rate limit	-	3,000
Dividend Allowance higher rate band	-	2,000
Taxable at basic rate	**29,000 (20%)**	-
Taxable at higher rate	-	**4,000 (32.5%)**

Winners and losers

Depending on the overall income and dividends you expect to receive, the new rules may have a greater or lesser impact on your finances. However, investors with modest income from shares are likely to see either a tax cut or no change in the amount of tax owing.

The following table shows a comparison between the tax rates prior to and post-6 April 2016.

	Basic rate band	Higher rate band	Additional rate band
Effective dividend tax rate prior to 6 April 2016	0%	25%	30.6%
Rate from 6 April 2016	7.5%	32.5%	38.1%

An example of a winner might be a higher rate taxpayer who has dividend income of £5,000.

For the 2015/16 tax year he would have a tax liability of £1,250 (25% of £5,000). However, in 2016/17 he will have no tax liability.

An example of a loser under the new rules might be the sole shareholder of a company who takes a small salary and then dividends up to the threshold at which higher rate tax is payable. Under the old rules, assuming the salary was below the Personal Allowance, there would have been no income tax to pay on the salary and no tax on the dividend. However, in 2016/17 only £5,000 of the dividends will escape tax.

To discover how the changes will affect you, please contact us for advice tailored to your particular circumstances.

Minimising the tax impact

Here we explore a few of the areas where it might be possible to save tax and thereby minimise the impact of the changes. Please note, this is intended as general guidance only and you are advised to seek expert help before taking action.

Maximising the Dividend Allowance

Under the new system, every individual will be entitled to a tax-free Dividend Allowance of £5,000 per annum. Married couples and civil partners might therefore want to consider spreading their investment portfolios in order to utilise each person's Dividend Allowance.

Trading as a limited company

If you have been trading as a limited company you may think that it would be preferable to trade as a sole trader or as a partnership from 6 April 2016. However, in many cases, continuing to trade as a limited company will still offer benefits in tax terms. The tax saved by incorporation compared to being unincorporated will be reduced, but there is still an annual tax saving.

Salary or dividend?

Historically, it has been favourable for a director-shareholder to take dividends rather than a salary. This is because a dividend is paid free of national insurance contributions, whilst a salary or bonus can carry up to 25.8% in combined employer and employee contributions. However, a salary or bonus is generally tax deductible for the company, whereas dividends are not.

So will it still be beneficial to take a dividend over a salary/bonus under the new rules? In fact, there may still be benefits for a director-shareholder taking a dividend over a salary, although the amount of tax saved will be reduced. Please ask us for further details.

Develop a tax-efficient savings strategy

Wherever possible, be sure to make the most of your tax-efficient savings and pension options. Despite interest rates being relatively low in recent years, Individual Savings Accounts (ISAs) can still be a useful tax-free savings vehicle. Individuals can invest in a combination of cash or stocks and shares up to the overall annual subscription limit, which remains unchanged at £15,240 for 2016/17.

From 6 April 2016, new measures aimed at improving flexibility now allow savers to replace cash they have withdrawn from their ISA account earlier in a tax year without this replacement counting towards the annual ISA subscription limit. Also from 6 April 2016, investors have the option to hold loan repayments, interest and gains from peer to peer loans within a new Innovative Finance ISA, without being subject to tax. Returns have the potential to be significantly greater than on cash ISAs, but they will carry a greater degree of risk.

You might also want to consider other tax-efficient investments such as Venture Capital Trusts (VCTs), which can generate tax-free dividends. If you have income from employment or self-employment you may also effectively reduce your marginal rate of tax on dividends by increasing pension contributions and taking advantage of the available tax relief – please ask us for further details.

Please note that this factsheet is for general guidance only. However, careful planning can help to save you money in the future, so please contact us for further assistance.