Changes to Dividend Taxation

Overview

There are major changes to the taxation of dividends from 6 April 2016. From the start of the 2016/17 tax year the government will introduce a 'dividend allowance' of £5,000 for each person, which will be in addition to their personal allowance. At the same time the 10% deemed tax credit on dividends will be removed and the tax rates payable on dividend income (above the £5,000 threshold) will increase. The new allowance does not apply to trusts.

For many taxpayers the new system will be simpler to understand but there will be some winners and losers in the process. Basic rate taxpayers with annual dividend income over £5,000 per annum will pay more tax, whilst some higher and additional rate taxpayers will find themselves paying less tax on their dividend income. In all cases it is worth looking at the impact of the new rules to see how we can take advantage of the new allowance and to minimise any increase in tax that might arise.

How is the system changing?

One of the complications of the current system involves the use of tax credits. Dividends paid to 5 April 2016 are deemed to be subject to have suffered a notional tax credit of 1/9th of the net dividend paid. A net dividend of £900 is treated as a gross dividend of £1,000 on which tax of £100 is deemed to have been paid. This notional tax credit satisfies any basic rate tax liability, but higher rate or additional rate tax payers pay some additional tax on this dividend income at the rates shown in the table below. These tax rates for dividend income are lower than the standard higher and additional rates of income tax on earned income and savings.

From 6 April 2016 the complication of the tax credit is removed. Dividends within the £5,000 allowance are tax free, but for dividends above this level there are different bands of tax payable. Basic rate taxpayers will pay 7.5% tax on dividends above the allowance, whilst higher and additional rate taxpayers will pay tax at 32.5% and 38.1% respectively.

	Dividends paid to 5/4/16	Dividends paid from 6/4/16 (over £5,000)
Nil rate	nil	nil up to personal allowance
Basic rate	nil	7.5%
Higher rate	25% on net dividend	32.5%
Additional rate	30.56% on net dividend	38.1%

An individual with no income other than dividend income of £16,000 per annum will pay no tax under the existing rules or under the new rules as the dividends over the £5,000 dividend allowance will be covered by the personal tax allowance (which rises to £11,000 in April 2016).

As the level of dividend income increases the position changes. For example an individual with dividend income of £40,000 and no other taxable income would pay no additional tax on these dividends under the current system. From April 2016 £5,000 of the dividends would be covered by the dividend allowance and

£11,000 by their personal allowance, but the balance of £24,000 would be subject to tax at 7.5% giving rise to tax payable of £1,800.

Higher and additional rate tax payers will benefit from the new allowance but pay higher rates of tax on the excess. The position is complicated as the 'dividend allowance' can use up part of an individual's basic and higher rate tax threshold. In some cases it will be worth taking specific tax advice to quantify the impact of the new rules.

As a rule of thumb a higher rate taxpayer with dividend income below £21,660 p.a. will be better off under the new rules. For additional rate taxpayers with other non-dividend income in excess of £150,000 the tipping point is slightly higher at around £25,300 p.a.

Points to consider

For many investors the new annual dividend allowance will make the taxation of portfolios of unit trusts and similar collective investments easier to understand.

Where couples have dividend income in excess of £5,000 it will make sense to review how these investments are held to ensure that both parties are able to make use of their individual dividend allowances. For clients with relatively large portfolios of directly held collectives we will need to assess whether it makes sense to transfer these into a more tax efficient wrapper. Any decision will depend on a client's individual circumstances and we will need to ensure that the benefits of any change outweigh the costs and tax arising on the transfer.

The introduction of the dividend allowance opens a number of opportunities for high and additional rate taxpayers as we now have the ability to create a tax efficient portfolio of funds that makes full use of the dividend allowance and capital gains tax allowances. This is particularly helpful for individuals caught by the new restrictions on pension contributions as we can use the new allowances to build up a portfolio of collective funds and, as these grow, look to move funds into other tax wrappers such as offshore bonds. Business owners will also need to think carefully about whether to accelerate the payment of dividends before the higher tax rates come into force next year.

The precise impact of the changes will depend on your tax position and you may need to speak to your accountant to work out the implications in detail. If you have any questions on the new rules, or the potential implications for your portfolio please do not hesitate to contact us.

Martyn Torevell

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