

## Contractor guide to calculating taxes payable on dividends

Contractors who contract through their own [contractor limited company](#) and whose contracts are outside [IR35](#) will generally find taking a [dividend](#) as payment, together with a [minimal salary](#) up to the level of the tax-free allowance, the most tax efficient method of taking their contracting earnings from their company.

Those contractors with gross earnings – and that includes their income from all sources, including salary, dividends and, for example, income from investments or trusts – of less than the higher rate tax threshold (£37,401 at the time of writing), will find that they do not pay income tax on dividends because of the dividend tax credit.

Higher-earning contractors with gross incomes above the higher rate tax threshold, or even over the top rate of tax, will find that they must calculate the amount of income tax they must pay.

### What is a dividend tax credit?

Before going further, it's important to note that dividends can only be declared from profits made by a contractor limited company. Also, and this is where the tax benefits come in, all dividend payments are free from National Insurance Contributions (NICs).

Because all contractor dividends are paid after the contractor limited company has already paid corporation tax at 21% on the profits, to avoid paying tax twice ('double taxation'), dividend payments carry a 'tax credit'. That means the taxman assumes tax of 10% has already been paid on the dividend.

Contractors may see the phrase 'a dividend tax credit franks the net dividend for the basic rate of taxation'. All this means is that the taxman considers that basic rate taxpayers have already paid tax of 10% on the dividend, via corporation tax paid by their limited company, and have no more tax to pay.

What this also means is that there is what's known as a gross dividend, which is what the dividend would be if not for the tax credit. The gross dividend is calculated by 'grossing up' the net dividend. To 'gross up' the dividend, multiply the net dividend, which includes the tax credit remember, by 10/9. This is important, because when a contractor needs to declare their taxable income, the calculation must use the gross and not the net dividend.

So if the contractor limited company pays a dividend of £9,000, the tax credit is 10% of the gross dividend, or £1,000, and the grossed-up dividend is £10,000. What the contractor actually receives is £9,000, and what goes into the paperwork as taxable income is £10,000.

Dividend tax credits also apply to higher and top-rate taxpayers earning over the tax allowances. But because the rates for these tax bands are higher, contractors will be liable for additional income tax over and above the 10% dividend tax credit.

### Calculating dividend tax credits and income tax on dividends

Because the calculations are complex and get more so the higher a contractor's earnings, contractors who want to calculate their tax credits can use the ContractorCalculator Dividend Tax Calculator on this website, or ask their accountant. But to show how the final tax figures are arrived at, here are some examples.

The dividend tax rates (at the time of writing) are as follows:

Tax band	Tax rate	From	To	Gross rate (Tax rate - 10% credit)	Equivalent net rate
Basic rate	10%	0	£37,400	0%	0.00%
Higher rate	32.5%	£37,401	£150,000	22.5%	25.00%
Additional rate	42.5%	£150,001	-	32.5%	36.11%

The gross rate of tax is what is applied to the gross dividend. The dividend tax up to £37,400, the higher rate tax threshold, is 10%. But there is a tax credit of 10% and the taxman assumes this has already been paid through corporation tax, so in fact there is no tax to pay for basic rate tax payers. The "equivalent net rate" is the equivalent percentage applied to the net dividend, and is equal to the gross rate multiplied by 10/9.

Looking at an example of a contractor whose earnings take him/her above the higher rate, a contractor deciding to pay a net dividend of £60,000 plus a basic tax-free salary of £6,000 would pay an additional £6,478 in income tax.

How did these figures arise? To keep things simple, let's say the contractor made a profit of £75,949, on which £15,949 in corporation tax at 21% is payable. That leaves a profit of £60,000, which the contractor decides to take as a dividend.

In order that the taxable income can be used to calculate the income tax liability, the first step is to gross up the dividend to allow for the dividend tax credit, by multiplying £60,000 by 10/9, to give £66,667. Then add the basic tax-free salary of £6,000 to total £72,667. Take away the tax-free allowance of £6,475 (correct at the time of writing) and that results in a taxable income of £66,192.

Plug £66,192 into the dividend tax table:

Taxation rate	Percent	From	To	Gross rate	Tax (£)
Basic rate	10%	0	£37,400	10%	0
Higher rate	32.5%	£37,401	£150,000	22.5%	£6,478
Additional rate	42.5%	£150,001	-	32.5%	0

So, the first £37,400 is tax free. The difference of £37,400 and £66,192 is £28,792, which attracts a gross rate of 22.5% income tax; 22.5% of £28,792 is £6,478.

So, based on the £60,000 dividend and £6,000 salary, there would be an income tax bill of £6,478. Using ContractorCalculator's [Dividend Tax Calculator](#), which always incorporates up-to-date allowances, is very much simpler!

### Reducing personal allowances and top rate taxpayers

Contractors earning over £100,000 per year also get hit by the reducing personal allowances introduced in the [2010 Budget](#) alongside the 50% top rate of tax. The personal allowance reduces by £1 for every £2 over £100,000 earned, so everything a contractor earns over £100,000 is effectively taxed at 51% up to £112,950, after which the entire allowance (assuming a tax code of 647L) is wiped out.

To put this into context, a contractor earning over £100,000 a year works every day until lunchtime for the Chancellor before they start to pocket any money themselves. If a contractor is hovering just above the threshold, then an option is to share dividends with a spouse or partner by splitting dividends, or paying a salary. However, the spouse must be genuinely contributing to the business, or HMRC may consider applying Section 660 which treats the spouse's income as if it were the contractors and applies taxation accordingly.

The top rate of tax on dividends kicks in when contractors are earning over £150,000, and the net rate is 42.5%, so contractors can expect to pay 42.5% tax on their gross dividend payments over £150,000. This is an effective rate of tax of 36.11% on the net dividend.

“ A contractor earning over £100,000 a year works every day until lunchtime for the Chancellor before they start to pocket any money themselves ”

### Tax returns and non-refundable tax credits

Although the taxman may seem 'generous' in assuming the 10% tax on dividends has already been paid, this dividend tax credit is not refundable. So, even if a contractor's income is less than the personal allowance, it is not possible to make a claim for repayment. Contractors should therefore ensure the basic rate allowance is fully utilised to gain maximum benefit without incurring further tax.

Ideally, a [contractor accountant](#) should complete a limited company contractor's tax return as the calculations and allowances are complex, particularly if the contractor has many revenue streams that include, for example, savings and investments.

All dividend payments in a financial tax year should be included on the tax return, including dividends from shares held in other companies as well as in the contractor's limited company.

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