Contractor guide to dividends and dividend tax credits

Limited company contractors outside IR35 typically pay themselves a salary up to the National Insurance Contributions (NICs) lower earnings limit – £7,956 at the time of writing – with the balance taken as dividends from the profits of their business.

However, calculating the income tax payable on dividends can be a complex process. HMRC's rules say that contractors benefit from a tax credit, but that they should also be paying the same level of income tax on the money as if they earned it directly.

For contractors who would rather not attempt to work out how much dividend tax to pay, ContractorCalculator has a dividend tax calculator that calculates the taxes payable for them.

Dividends are paid out from company profits

A contractor limited company generates fee income, or revenue, and also incurs costs and expenses. Things like the contractor's salary and accountancy fees are generally paid directly by the company, while items like travel and subsistence expenses are paid by the contractor personally, and later claimed back from the company.

The company's gross profit is calculated by subtracting those costs and expenses from the revenue. The company then pays corporation tax at the prevailing small companies rate, which is currently 20%. What is left over is the net profit.

This profit can either be reinvested back into the company or, as is usually the case with contracting businesses, declared as a dividend and distributed to the shareholders. The principle is exactly the same as owning shares in a public company, which can pay out dividends during the course of its financial year.

Calculating taxable income

Most contractor limited companies are owned by a single contractor, or a single contractor and their spouse or civil partner. If a single share is issued to the contractor owner, that means all of the dividend is paid to that single shareholder.

If a company is co-owned by spouses or civil partners, then the dividend is shared between the spouses according to their shareholding, which is typically 50:50.

The contractor's taxable income is calculated by subtracting the personal allowance from the income: Taxable income = income minus personal allowance. The personal allowance for 2014/2015 tax year is £10,000, and most contractors will have a tax code of 1000L.

So, if a contractor earns £50,000 from dividends alone, with no other sources of income including salary, and their tax code is 1000L, then the taxable income is £40,000 (£50,000 minus £10,000).

HMRC's tax rules on dividends

HMRC's rules say that there is no further tax to pay on the profits that are within the basic rate allowance, which is £31,865. With taxable earnings of £40,000, subtracting the basic rate allowance leaves £8,135 on which the contractor will pay the same amount of tax as a higher rate taxpayer, ie 40%.

The rules get a little complex here, and hinge on the dividend tax credit. So, if the amount of fee income to be taxed before corporation tax was £100,000, the post corporation tax amount is £80,000. To then get to the equivalent of 40% of £100,000, a further 25% of £80,000 – ie £20,000 – must be paid.

The process of calculating the dividend tax is as follows:

Gross up the net dividend by 10/9. This accounts for the dividend tax credit

Calculate the dividend tax credit, which is 10% of the gross dividend calculated in step 1

Work out the taxable income portion of the dividend by subtracting the salary, which for most contractors will be £7,956, and other income

Apply the dividend tax rates according to the table below: 10%, 32.5% and 37.5%. Remember, what these rates are doing is taking the tax paid up to the same amount as would be paid if the dividend was employment income

Then reduce the tax paid on the taxable income by 10%, applying the dividend tax credit.

The results can be seen more clearly here:

Band	Percent	From	To	Gross rate

Basic rate	10.00%	0	£31,865	0.00%
Higher rate	32.50%	£31,866	£150,000	22.50%
Additional rate	37.50%	£150,001		27.50%

Dividend tax credits

Grossing up the dividend by 10/9 and then subtracting the dividend tax credit of 10% puts you back where you started. The following example assumes a dividend of £20,000 is being paid, in addition to a salary:

£20,000 x (10/9) - 10% = £20,000

The same principle applies to the higher rate:

£80,000 x (10/9) x 32.5% - £80,000 x (10/9) x 10% = £20,000

Grossing up the £80,000 dividend, applying the higher rate tax of 32.5%, and then applying the dividend tax credit of 10% is actually the same as applying 25%. But the reason this is done is because of the rules over dividend tax credits, and this is also where calculation mistakes are common.

Dividend tax credits are not a refund

Dividend tax credits can only be applied to tax that has already been paid, and it is not a refund. If a contractor with no other income receives a net dividend of £20,000, the gross dividend would be £22,222.

The contractor would have a dividend tax credit equal to £20,000 x (10/9) x 10% = £2,222. But, with a personal allowance of £10,000, this leaves £12,222 subject to tax at the basic rate.

This is taxed at 10% (£1,222) and the contractor can use some, but not all, of their tax credit to ensure they are not subject to further tax. So they can use £1,222 of their tax credit, leaving no tax due. What they cannot do is take off the full £2,222.

Many online dividend tax calculators make the mistake of treating the credit as if it were a refund, and so deliver incorrect results. A calculation that subtracts the whole tax credit is only valid if the contractor already has other income that is greater than or equal to their personal allowance.

That's why, unless you're very confident, it's best to have your accountant do the calculation, or use ContractorCalculator's dividend tax calculator.

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Choosing a salary level following the introduction of the Employment Allowance

Until the start of the 2014-15 tax year and the introduction of the Employment Allowance, the most tax efficient level of salary was at the NIC lower earnings limit of £7,956, as NIC thresholds had not kept pace with the increases in the personal allowance.

The introduction of the Employment Allowance now provides all employers, including contractor limited companies, with a £2,000 contribution towards employer's NICs. Contractors with no other income apart from salary and dividends could save up to £164 a year by using the full amount of the personal allowance up to £10,000.

This is because the corporation tax savings from paying the extra salary are greater than the cost of employee's NICs, and no employer's NICs will be due on a salary of £10,000 as a result of the £2,000 allowance.

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