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. There is a further tax on dividend payments but you'll find you'll pay much less tax than you would if you paid yourself all your earnings via a salary.

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 (£32,010 for the tax year 2013/2014), 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 themselves with some dividend tax to pay and must calculate the amount of income tax due.

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 20% 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 on dividend payments.

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 on dividend income over and above the 10% dividend tax credit.

Calculating dividend tax credits and income tax on dividends

Calculating the tax due on dividends can be a complicated. 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 (for tax year 2013/2014) are as follows:

Tax band	Tax rate	From	To	Gross rate (Tax rate - 10% credit)	Equivalent net rate
Basic rate	10%	0	£32,010	0%	0.00%
Higher rate	32.5%	£32,010	£150,000	22.5%	25.00%
Additional rate	37.5%	£150,001	-	27.5%	30.56%

The gross rate of tax is what is applied to the gross dividend. The dividend tax up to £32,010, 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 £8,000 would pay an additional £7,472 in income tax.

How did these figures arise? To keep things simple, let's say the contractor made a profit of £75,000, on which £15,000 in corporation tax at 20% 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 £8,000 to total £74,667. Take away the tax-free allowance of £9440 (tax tables for 2013/2014) and that results in a taxable income of £65,227.

Plug £65,227 into the dividend tax table:

Taxation rate	Percent	From	To	Gross rate	Tax (£)
Basic rate	10%	0	£32,010	10%	0
Higher rate	32.5%	£32,010	£150,000	22.5%	£7,473
Additional rate	37.5%	£150,001	-	27.5%	0

So, the first £32,010 is tax free. The difference of £32,010 and £65,227 is £33,217, which attracts a gross rate of 22.5% income tax; 22.5% of £33,217 is £7,473.

So, based on the £60,000 dividend and £8,000 salary, there would be an income tax bill of £7,473. 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 45% 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 60% up to £118,880, after which the entire allowance (assuming a tax code of 944L) 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 – thus lowering their tax liability on dividends.

However contractors attempting to lower the tax they pay on dividends this way must ensure their spouse qualifies for a 'spousal exemption' from the **settlements legislation** (formerly known as Section 660), or HMRC may consider applying the legislation which treats the spouse's income as if it were the contractors and applies income and dividend taxation accordingly.

The top rate of tax on dividends kicks in when contractors are earning over £150,000, and the net rate is 37.5%, so contractors can expect to pay 37.5% tax on their gross dividend payments over £150,000. This is an effective rate of tax of 30.56% on the net dividend.

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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 tax on their dividend income.

Ideally, a **contractor accountant** should complete a limited company contractor's tax return as the calculations for dividend taxation 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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