Dividend Tax rules change 2016 - new calculations explained

Contractor Dividend Taxes changed in April 2016, increasing tax bills for all contractors and small business owners. The government introduced the measure in the **Summer Budget 2015** to reduce the difference in tax paid by individuals working as sole traders or partners versus those operating through limited companies, and to cut 'tax motivated incorporation'.

Contractors now face a simple rate of tax on net dividends, as opposed to the former system whereby contractors would gross-up dividends. The tax bands are 7.5% for basic rate taxpayers, 32.5% for higher rate taxpayers and 38.1% for additional rate taxpayers. There is a Dividend Allowance, which according to HMRC's factsheet is not actually an allowance but a zero rate band, and the previous dividend tax credit basis no longer exists.

"The change will increase marginal rates of tax by 6% for all limited company owners, including contractors and freelancers," highlights James Abbott, founder and head of tax at contractor accountant **Abbott Moore**. "Contractors paying a dividend up to the higher rate threshold who previously paid no extra income tax on these dividends will now pay dividend tax in excess of £1,700 per year."

Dividend Tax changes - explained

According to Abbott, the way that dividends are taxed has completely changed: "Using the previous rules, a contractor would declare a dividend and then gross-up that net dividend by ten ninths to arrive at a gross dividend, including tax credit of 10%.

"For example, for every £100 of profit earned, a contractor's company would have paid 20%, or £20, in corporation tax, leaving £80 to be paid as a dividend. That would then have been grossed up to £88.89 to find out which personal tax band the dividend fell into and then used in a contractor's self-assessment tax return as their income. Basic rate taxpayers would have paid no additional income tax on dividends. The higher rate was set at 25% of the £80 and the additional rate was 30.55% of the £80."

That's all changed. Now the new Dividend Tax rates are applied to all net dividends, deducting an individual's personal allowance not used by salary or other income. The new rates are 0% for the first £5,000 (called the Dividend Allowance), 7.5%, 32.5% and 38.1% for basic, higher and additional rate taxpayers respectively.

There is one other factor that Abbott says means the impact of the new tax will be slightly less than feared: "The new rules say that for every £100 profit, 20% or £20 of corporation tax is deducted and then the Dividend Tax applies to the remaining £80. What this does is actually delay the point when a contractor starts to pay higher rate tax, because the net dividends are no longer grossed up."

How to calculate the Dividend Tax payable on contractor limited company dividends

"Although this is an attempt at simplifying the rules, because a new tax allowance in the form of the Dividend Tax Allowance is added, the calculation becomes more complex." continues Abbott. "Further complications arise due to child benefit and the withdrawal of the personal allowance on earnings over £100,000."

Abbott explains, using an example of a fairly typical contractor with annual profits of £80,000:

The contractor has £80,000 of profits in the company, but only wants to declare a dividend to take them to the higher rate threshold, and remain in the basic rate band

In April 2016, the personal allowance increased to £11,000 and the higher rate threshold increased to £43,000, so there are £32,000 of earnings that will attract the basic rate of tax. The Dividend Allowance is £5,000, so that means that the first £5,000 is taxed at 0%. The remaining £27,000 is taxed at 7.5%

Based on 2016/17 National Insurance Contribution (NICs) thresholds, the recommended optimal salary is £8,060 a year.

The Dividend Tax is calculated as follows:

If a contractor is paying a salary of £8,060, assuming they have no other income then they can take £34,940 of taxable dividends to bring their total earnings up to the higher rate threshold of £43,000

The Dividend Allowance taxes the first £5,000 at 0%. That means the total dividend that keeps the contractor within the basic rate will be £29,940

The £29,940 less the £2,940 remaining of the contractor's personal allowance (remember dividends don't attract NICs like salary does) leaves £27,000 that is subject to dividend tax

7.5% of £27,000 is £2,025.

"In conclusion, a contractor paying a dividend up to the higher rate threshold will pay an additional £2,025 in Dividend Tax," says Abbott. "If the contractor decided to take an additional £10,000 dividend on top to £39,940, they would apply the higher rate of dividend tax, which is 32.5%, to the £10,000 and pay an extra £3,250 in Dividend Tax. The total tax to pay will be £5,275."

Using net dividends has tax reducing benefits

Abbott acknowledges that there is little that can be done other than aggressive tax avoidance for contractors to avoid the Dividend Tax, with the exception of diverting profits into a company pension scheme, but there are some benefits of using net dividends to calculate the tax.

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James Abbott is the owner of Abbott Moore LLP and often speaks on freelancer / contractor tax matters. He has his own growing portfolio of contractor clients.

Abbott Moore LLP are PCG Accredited Accountants and specialise in providing tax advice to freelancers as well as dealing with their year end accounts and tax returns. **Read Full Profile...**

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He concludes: "Because contractors no longer have to gross-up the dividend, they are actually able to earn more before the increased marginal rates caused by the withdrawal of child benefit on incomes over £50,000 and the personal allowance on incomes over £100,000 take effect.

Updated: Thursday, May 5, 2016