Spring 2016

Tax Change on Dividends from 6 April 2016

I am sure a number of you are aware of the fact that the system for taxing dividend income on individuals is to be changed from 6 April 2016. The 8 July Budget was a bad budget for family companies. Hard working entrepreneurs are to be hit with a new tax on their dividends.

The government have stated that their objective is to reduce the difference between the tax paid by individuals working as sole traders or in a partnership versus those operating through limited companies. This will affect you if you receive dividends either from investments or as part of your income from a company which you own and manage (OMC).

Overview of The Changes

Currently a basic rate taxpayer pays no tax on their dividend income. Only higher rate or additional rate taxpayers pay tax on their dividend income of an effective rate of 25% or 30.6% respectively.

The existing system of grossing-up dividends will be abolished and replaced with a simple rate of tax on net dividends. From 6 April 2016 dividend income above £5,000 will be taxed at 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 will disappear.

The exact effect on tax payers will depend on each person's individual circumstances.   However, in general:

- Basic rate taxpayers with dividends above £5,000 will be worse off;
- Basic rate taxpayers with dividends below £5,000 will see no change;
- All higher and additional rate taxpayers with dividends below £5,000 will be better off;
- Where non-dividend income is sufficient to make a taxpayer subject to higher rate (or additional rate) tax, the combination of the dividend exemption and changed rates means that a higher rate taxpayer with dividends up to £21,667 is likely to be better off (up to £25,232 for additional rate taxpayers);
- However, all those with significant dividends, and low income from other sources (such as those taking a low salary and high dividends out of an owner managed company) will be worse off; some significantly so. This is irrespective of whether they are basic, higher or additional rate taxpayers.

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What can be done?

General investors may have little option other than to pay up or decide to pursue a different investment strategy but there are some points you could consider which are set out below.

However, shareholders in OMCs may have more ability to plan their income levels.

Owner Managed Companies

The dividend policy of companies will need to be tailored to the disposable income needs and tax position of individual shareholders so that the effect of the new dividend rates can be minimised. Although the changes will adversely affect most shareholders of family businesses they certainly do not negate the overall tax and other benefits of incorporation compared to a sole trader or partnership business.

Low salary and high dividends are likely to remain a more effective tax strategy where feasible, but the tax saving will narrow. Some planning points to consider are:

- Dividends could potentially be accelerated into the 2015/16 tax year before rates go up, with future dividends being reduced accordingly. However, this needs considering case by case, as:
    - Additional dividends might push your total income into a higher tax bracket;
    - You will need sufficient cash flow to pay the income tax due in January 2017, even if the dividend itself is not drawn in cash (where the company needs the cash for working capital etc. then the money could be re-invested in the company as a director's loan); and
    - The dividend must be declared properly, including ensuring there are sufficient distributable reserves available and that the paperwork is all completed correctly.

  Although advancing dividends in this way will advance the tax due on dividend income, this disadvantage will be outweighed by the tax savings.

- Sharing income appropriately around the family (for instance, splitting company shares with a spouse, if carefully implemented, to take advantage of personal allowance / basic rate band);
- Flexing the level of income drawn year on year to improve the position;
- How the company should interact with your pensions planning;
- Tax efficient benefits in kind;
- Any different forms of profit extraction available.

General Investors

Some points you may wish to consider to mitigate this tax increase are:

- Use your ISA allowance now. Unlimited dividends can be withdrawn from an ISA tax-free, which is why sheltering taxable investments in the accounts will become all the more important.
- Consider a SIPP. SIPPs (Self-Invested Personal Pensions) also have the benefit of tax-free dividends. For retirement savings where money is not needed until age 55 the tax benefits of SIPPs make it a good option for many.
- Maximise your annual tax-free dividend allowance. Married couples and registered civil partners should spread their taxable portfolios between them to make full use of each person's allowance.
  Couples should also make full use of personal allowances and basic rate tax bands, where applicable, so that taxable dividends are paid in the name of the spouse who pays the lowest tax rates.
- Be clever with yield. A diverse portfolio will have shares and funds that generate different levels of dividend income yield. Consider sheltering those that generate the highest yields in an ISA to maximise the dividend income tax allowance.
- Reduce other income. Dividend tax is linked to the rate of income tax you pay, so look to move down a tax band where possible. For instance, in some cases taxable income for a particular year could be reduced. Think about transferring income bearing assets such as cash deposits to a lower earning spouse, or deferring withdrawals from a drawdown pension until a new tax year.
- Invest in VCTs. For taxpaying, sophisticated investors, happy to take higher risks, Venture Capital Trusts (VCTs) generate tax-free dividends. These tax-free dividends will be payable in addition to tax-free dividends from an ISA and tax-free dividends within the new £5,000 Dividend Allowance.

If you are affected by the issues discussed in this briefing and would like more information concerning your own personal circumstances, please contact our office and speak to Alok or Jenny.

Jenny Mitra

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