DIVIDEND TAX CHANGES & PROFIT EXTRACTION

LOOKING AT THE NEW DIVIDEND TAX REGIME AND ITS IMPACTS

YOUR PERSONAL CFO
NAVIGATOR FINANCIAL PLANNING

DIVIDEND TAX – WHAT'S CHANGING?

New rules on dividend taxation will come into force in the new tax year. The tax credit will be scrapped and with it the need to gross up dividends for calculating individual liability. **An additional tax of 7.5% will apply to all net dividends**. There will be a new dividend annual allowance of £5,000, up to which tax will not apply[1].

So what is the impact? In short, it means additional tax on SME business owners. HMRC estimate that 85% of individuals will be better or no worse off under the new rules, but still expect it to raise an additional **£2bn**. The majority of this will come from business owners paying themselves dividends.

Below are the effective rates of tax on net dividends taken, above the £5,000 allowance, before and after the change:

	2015/16	2016/17
Non taxpayers	0.0%	0.0%
Basic rate payers	0.0%	7.5%
Higher rate payers	25.0%	32.5%
Additional rate payers	30.6%	38.1%

These changes will impact business owners withdrawing profits from their companies. Below we will run through the different methods of profit extraction and how this tax change could affect their relative merits. An appendix has been included at the end of the document detailing effective rates of tax.

1.) Dividends

If we consider the case of business owners paying themselves an £8,000 salary and then withdrawing £50,000 worth of profit through dividends, we can see the impact of the new tax. *We will use the 2016/17 tax bands for simplicity:*

	Old Regime	New Regime
Salary	£8,000	£8,000
Profit	£50,000	£50,000
Corporation Tax	-£10,000	-£10,000
Net Dividends	£40,000	£40,000
Income Tax	-£2,125	-£3,650
Net Earnings	£45,875	£44,350

In the example the new rules have resulted in an **additional £1,525 income tax** bill. Here £27,000 of net dividends are taxed at the basic 7.5%, and £5,000 are taxed at the higher rate of 32.5% (the remaining £8,000 being covered by remaining personal allowance and dividend allowance).

[1] Despite the name, this is a nil-rate band, rather than an allowance, in that it will not reduce taxable income.

Under the old regime £31,500 of net dividends (£35,000 gross) would have suffered no further tax (covered by the tax credit), with the remaining £8,500 net dividends subject to 25% tax.

2.) Salary/Bonus

The new dividend regime will still be far more attractive than paying additional salary/bonus, due to avoiding National Insurance Contributions (NICs). If we consider the previous example, the £50,000 of profit could have provided a £43,950 bonus (after employer NICs).

When combined with the £8,000 salary, this would incur £14,352 of income tax and employee NICs, giving £37,598 net total earnings. This is some £6,752 less than with taking net dividends under the new regime.

Consider also that the calculations assume Corporation Tax at 20%. Corporation Tax in Northern Ireland is due to be reduced to 12% in 2018, which will reduce the total tax burden for business owners and further improve the desirability of drawing dividends rather than salary.

3.) Self-employed

Up to this point we have only considered limited companies. However, many may now reconsider whether a limited company is the most appropriate structure for their business.

For fair comparison with the previous example we can look at self-employed earnings of £58,000 – the combined salary and profit. A Self Employed business owner would incur £12,400 income tax and £3,590 of NICs (Class 2 and 4), giving a net income of £42,010. Whilst substantially better than a limited company director taking salary/bonus, this is still £2,340 less than under the new dividend regime.

It is worth noting there are other benefits of partnerships and sole trading, in particular reduced administration and the potential for running cost effective company cars. Of course, there is also the possibility of having multiple business structures, including limited companies and partnerships or sole trading firms.

Retained Profits

For the majority of business owners, the new dividend regime will be more penal than the last. With that in mind, where large retained profits exist, it could be worth distributing dividends in the 2015/16 tax year, before the new rules come into effect, in order to benefit from lower effective rates of tax. Where sums are still required in the business, it could be possible to organise a director's loan, using the distributed amounts.

The decision to bring forwards dividends will not be a straightforward one. For example, if entitlement to the personal allowance was lost as a result, effective rates of tax could be higher. Furthermore, amounts left in the business may qualify for Entrepreneur's Relief and/or Business Property Relief. Consequently, advice should be sought from your accountant, tax advisor or financial planner before proceeding.

Pension Contributions

The additional dividend tax will make employer pension contributions more attractive. Contributions are an allowable expense, in the majority of cases, and give no immediate liability to personal tax. When drawn from a pension, 25% can be taken as a tax-free lump sum, with the remaining 75% providing a taxable income. Furthermore, pension income is often drawn when earnings are lower, such as in retirement, leading to lower marginal rates of tax being incurred.

Pension contributions are particularly attractive for those over 55, who can now access amounts from pensions with complete freedom. Amounts held in pensions can also pass to beneficiaries as 100% tax free lump sums in the event of death (prior to age 75[2]) and are not subject to Inheritance Tax (IHT), making them very efficient for passing assets down generations too.

You should consult your professional advisors, starting with your financial planner, before making sizeable pension contributions, to ensure tax efficiency.

In Summary

- Most people drawing remuneration from limited companies by way of dividends will pay more tax from 2016/17
- Drawing dividends will, in most cases, still result in more net income
- Employer contributions to pensions will become even more attractive from 2016/17

[2] Post age 75, beneficiaries can withdraw sums subject to income tax at their marginal rate of tax.

Appendix – Effective rates of tax on profit extraction

Below is a table setting out the effective rates of tax, based on the example shown i.e. £8,000 salary and £40,000 dividends or £58,000 of salary/bonus. The calculations include the personal allowance, dividend allowance and the primary and secondary thresholds for NICs.

	Old Dividend Regime	New Dividend Regime	Salary/ Bonus	Self-Employed
Profit/Earnings	£58,000	£58,000	£58,000	£58,000
Salary/Bonus	£8,000	£8,000	£58,000	£58,000
Corporation Tax	-£10,000	-£10,000	£0	£0
Dividends (net)	£40,000	£40,000	£0	£0
Income Tax	-£2,125	-£3,650	-£9,980	-£12,400
National Insurance	£0	£0	-£10,422	-£3,590
Net Income	£45,875	£44,350	£37,598	£42,010
Effective Rate of Tax	20.9%	23.5%	35.2%	27.6%

YOUR PERSONAL CFO

NAVIGATOR FINANCIAL PLANNING