Working out your dividend tax bill

Dividends are a special case when it comes to tax and have their own rates and rules. The taxation of dividends was radically reformed from 6 April 2016 and the rules outlined below apply to a dividend paid on or after that date.

Dividend income

The first step to working out tax on dividend income is to determine the amount of that income. From 6 April 2016, this is simply the dividends actually received in the tax year. There is no longer any need to gross up as dividends no longer come with an associated tax credit.

Dividend allowance

The first £5,000 of dividend income is tax-free. All individuals, regardless of whether they are a non-taxpayer, a basic rate taxpayer, a higher rate taxpayer, or an additional rate taxpayer, are entitled to a dividend allowance of £5,000.

Although referred to as an allowance, the dividend allowance works as a nil rate band in that dividends falling within the allowance are taxed at a notional zero rate (so received tax-free). However, it counts as earnings and will use up part of the basic or higher rate band, as applicable.

The Government plans to reduce this allowance to £2,000 from 6 April 2018.

Rate of tax

Once the dividend allowance has been used up, the rate at which dividends are taxed depends on the tax band in which they fall. If the individual has some or all of his or her personal allowance available, this can be set against dividend income before any tax is payable. Where the taxpayer has other sources of income, dividends are treated as the top slice. It is important to remember this to ensure that dividends are taxed at the correct rate.

Dividends are taxed at the dividend rates of tax, rather than the standard income tax rates. For 2017/18, dividend tax rates are as follows:

- dividend ordinary rate: 7.5%
- dividend higher rate: 32.5%
- dividend additional rate: 38.1%

The dividend ordinary rate applies to dividend income falling within the basic rate band, which for 2017/18 is the first £33,500 of taxable income. This applies to Scottish taxpayers too, rather than the Scottish basic rate band.

The dividend higher rate applies where taxable dividend income sits in the band between £45,001 and £150,000 and the dividend higher rate applies where dividend income falls in the additional rate band (taxable income above £150,000).

Case study

In 2017/18, Fiona receives dividend income of £55,000. She also receives a salary of £8,000 from her family company. The tax payable on her dividends is worked out as follows:

- The first £5,000 is covered by the dividend allowance on which no tax is payable.

- The personal allowance for 2017/18 is £11,500 of which £8,000 has been used against her salary, leaving £3,500 available. This shelters the next £3,500 of dividend income, which is received tax-free.
- The basic rate band is £33,500, of which £5,000 has been used up by the dividend allowance, leaving £28,500 available. The next £28,500 of dividend income is taxed at the dividend ordinary rate of 7.5% -- a tax bill of £2,137.50.
- The remaining dividend of £18,000 is taxed at the dividend higher rate of 32.5% -- a tax bill of £5,850.

Thus, Fiona must pay tax of £7,987.50 on her dividend of £55,000 ((£5,000 @ 0%) + (£3,500 @ 0%) + (£28,500 @ 7.5%) + (£18,000 @ 32.5%)).