

Dividend income – How is it taxed in 2018/19?

The taxation of dividend income was reformed from 6 April 2016. Since that date, dividends are paid gross – there is no longer any associated tax credit – and all taxpayers receive a dividend allowance. Dividends not sheltered by the dividend allowance, or any available personal allowance, are taxed at the appropriate dividend rate of tax.

Dividend allowance

The 'dividend allowance' is available to all taxpayers, regardless of the rate at which they pay tax and unlike the savings allowance the amount of the dividend allowance is the same regardless of the tax bracket into which the recipient falls. Where the allowance is not otherwise utilised, it allows for tax-efficient extraction of profits from a family company.

Although termed an 'allowance' the dividend is really a zero-rate band, with dividends covered by the allowance being taxed at a rate of 0% (the 'dividend nil rate'). Significantly, dividends covered by the allowance form part of band earnings.

The dividend allowance is set at £2,000 for 2018/19; a reduction of £3,000 from the £5,000 dividend allowance that applied for the two previous tax years. Assuming dividends of at least £5,000 are paid in 2017/18 and 2018/19, the reduction in the dividend tax allowance will increase the tax payable by £225 for basic rate taxpayers, by £975 for higher rate taxpayers and by £1,143 for additional rate taxpayers.

Top slice of income

Dividend income is treated as the top slice of income. This determines which band it falls in, and the rate at which it is taxed.

Dividend tax rates

Dividend income has its own tax rates. Dividend income is taxed at 7.5% (the 'dividend ordinary rate') to the extent that it falls in the basic rate band, at 32.5% (the 'dividend higher rate') to the extent that it falls in the higher rate band, and at 38.1% (the 'dividend additional rate') to the extent that it falls in the additional rate band.

For 2018/19, the basic rate band covers the first £34,500 of taxable income. The additional rate band applies to taxable income in excess of £150,000. The bands are UK wide in their application to dividend income - the Scottish income tax bands apply only to non-savings, non-dividend income.

Personal allowance

If the personal allowance has not been fully used elsewhere, bearing in mind dividend income has the last call, any unused portion of the allowance can be set against dividend income. The personal allowance is £11,850 for 2018/19, although it is reduced by £1 for every £2 by which income exceeds £100,000.

Example

In 2018/19, Frances receives a salary of £25,000 and dividends of £30,000. Her personal allowance of £11,850 and the first £13,150 of her basic rate band is used by her salary, on which she pays tax of £2,630.

The first £2,000 of her dividends is covered by the dividend allowance and is tax-free. However, the allowance uses up £2,000 of her basic rate band, leaving £19,350 available (£34,500 - £13,150 - £2,000). The next £19,350 of dividends is taxed at the dividend ordinary rate of 7.5% and the remaining £8,650 (£30,000 - £2,000 - £19,350) is taxed at the dividend higher rate of 32.5%.

The tax payable on her dividends is therefore £4,262.50 ((£2,000 @ 0%) + (£19,350 @ 7.5%) + (£8,650 @ 32.5%)).

Planning tip

Having an alphabet share structure in a family company allows dividends to be paid to family members to take advantage of their dividend allowance to extract profits tax-free.