Impact of new dividend tax arrangements on Employee Shareholders

The UK Government's proposal, in the Budget on 8 July 2015, to change the method of taxing dividends will affect some employee shareholders. There will be particular implications for those who take Dividend Shares out of a tax-advantaged Share Incentive Plan ("SIP") in "bad leaver" circumstances.

Current system

Under the current system, UK resident individuals who receive cash dividends paid by UK companies are liable to income tax on the gross dividend at 10% (basic rate taxpayers), 32.5% (higher rate) or 37.5% (additional rate).

They are entitled to a tax credit of 10% of the gross dividend, which is equivalent to one-ninth of the net dividend received. The effective dividend tax rate is therefore 0% (basic rate taxpayers), 25% (higher rate) or 30.56% (additional rate).

UK residents who receive cash dividends from overseas companies are in most cases also entitled to a tax credit equal to one-ninth of the dividend (grossed up for any overseas tax).

Income tax on dividends is payable through self-assessment and so basic rate taxpayers who do not otherwise have to complete an annual tax return do not need to declare their dividends to HMRC.

SIPs

Employee shareholders are generally subject to income tax on cash dividends in the same way as other taxpayers. However, if dividends received on shares held in a SIP are reinvested to acquire Dividend Shares, there is no income tax charge on those dividends at that time.

When SIP participants cease employment they are required to remove their shares from the SIP. If the reason for ceasing employment is a "bad leaver" reason – for example voluntary resignation or dismissal – any Dividend Shares acquired in the previous three years will potentially become taxable. The taxable amount is equivalent to the dividend which was originally reinvested to acquire the shares. There is no tax charge for basic rate taxpayers, but higher and additional rate taxpayers pay tax at the effective rate of 25% or 30.56%.

Proposed new system

Under the new proposals, dividend tax credits will be abolished from 6 April 2016. There will be a new dividend tax allowance of £5,000 a year. The new rates of income tax on dividend income above this allowance will be 7.5% (basic rate taxpayers), 32.5% (higher rate) or 38.1% (additional rate). These new rates are all higher than the current effective rates.

This will mean that some higher and additional rate taxpayers, whose dividend income is no more than £5,000, will no longer have to pay income tax on their dividends. On the other hand, some basic rate taxpayers may have to start paying income tax on their dividends, when the tax was previous covered by the tax credit. This could mean that some individuals who do not currently have to complete self-assessment tax returns will have to start doing so, to declare their taxable dividends.

SIPs

In a similar way, some higher and additional rate taxpayers who currently have to pay income tax on their Dividend Shares when they cease employment in "bad leaver" circumstances will no longer have a tax liability for these shares. On the other hand, some basic rate taxpayers will have income tax to pay on their Dividend Shares.

There are already quite a lot of SIPs where some employees receive Dividend Shares each year in excess of the previous £1,500 limit (abolished with effect 6 April 2013). There are therefore likely to be some SIP participants who have acquired more than £5,000 worth of Dividend Shares in the previous three years. The £5,000 figure will, of course, include any other dividends which the employees receive during the relevant tax year outside the SIP (except on shares held in a tax-exempt ISA or pension plan).

We recommend that companies should start considering appropriate changes to their employee booklets and other communication materials for SIPs and other employee share plans.

For more information and advice on this issue please contact me or your usual MM&K consultant.

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