CHAPTER 4

THE TAXATION OF DIVIDEND INCOME

4.1 Introduction

A **"dividend"** is a distribution of profit by a company to its shareholders. Like bank interest, dividends are deemed to be paid net of tax, but this time the **tax credit** associated with the dividend **is 10%.**

ITA 2007, s.19

If a UK company has paid a dividend of £18,000 to a shareholder, the £18,000 is the amount of cash actually received.

10% tax is deemed to have been deducted at source from the dividend, thus giving a tax credit of £2,000. We add the tax credit on to the net dividend to give a gross dividend of £20,000. The tax credit is 10% of the gross dividend.

	£
Net dividend	18,000
Tax credit (10%)	2,000
Gross dividend	£20,000

We need to take the net dividend of £18,000 and **"gross it up"** for tax purposes. We do this by multiplying the net dividend by **100 over 90**. It is the £20,000 gross figure that will be entered into the dividend column in the income tax computation.

$$\pounds 18{,}000 \times \frac{100}{90} = \pounds 20{,}000$$

It is important to note here the tax credit associated with a dividend is a **notional tax credit**. This tax credit does not really exist in the eyes of HMRC and they will never repay it to a taxpayer.

Contrast this with tax deducted from interest income, or tax deducted under PAYE from salaries, which is proper tax and will be repaid to non-taxpayers.

4.2 Taxation of dividends

We keep dividends separate in the income tax calculation because they are charged at different rates of tax to non-savings income and bank interest. Dividends are always taxed as the top slice of a taxpayer's income. This means that dividends will be taxed after non-savings income and bank interest.

ITA 2007, s.16

There are three possible rates of tax which can apply to dividend income in 2010/11. **Dividends** can be taxed at the dividend ordinary rate of 10%, or the dividend upper rate of **32½%,** or the dividend additional rate of **42½%.**

ITA 2007, s.8

Any dividends falling below the **basic rate threshold** are charged at the dividend ordinary rate of 10%. Any dividend income in excess of the basic rate limit but below the higher rate limit is charged at the dividend upper rate of 32½%. Any dividend income **in excess of the higher rate limit** is charged at the dividend additional rate of 42½%.

In summary, non-savings income can be taxed at three rates of tax in 2010/11, being 20%, 40% and 50%.

Interest can be charged at four possible rates of tax, being the starting rate of 10%, (where taxable non-savings income is less than £2,440) the basic rate of 20%, the higher rate of 40% and the additional rate of 50%.

Dividend income can only be charged at three possible rates of tax, being the dividend ordinary rate of 10%, the dividend upper rate of 32½%, and the dividend additional rate of 42½%.

You will see here, therefore, there are six possible rates of tax applying to taxable income in 2010/11, being 10%, 20%, 32½%, 40%, 42½% and 50%!

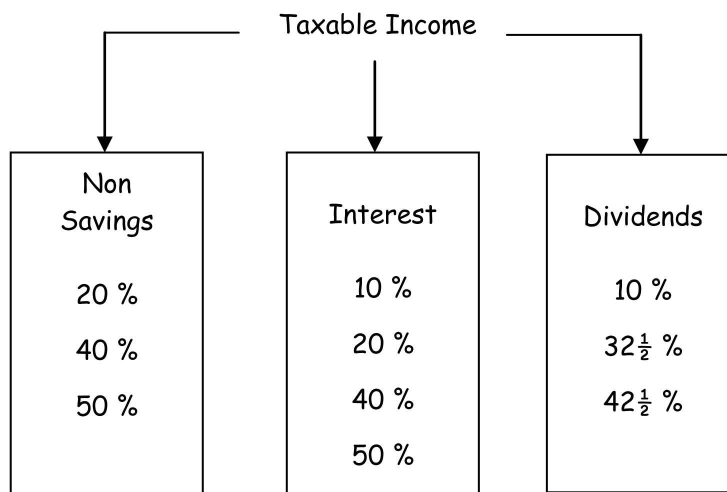

Illustration 1

Mrs Holder received the following income in 2010/11:

	£
Rental income	25,000
UK bank deposit interest	12,000
UK dividends	9,000

Mrs Holder's tax due will be calculated as follows:

	Non Savings	*Interest*	*Dividends*
	£	£	£
Property Income	25,000		
Bank Interest			
(£12,000 x $\frac{100}{80}$)		15,000	
UK dividends			
(£9,000 x $\frac{100}{90}$)			10,000
Net Income	25,000	15,000	10,000
Less: Personal allowance	(6,475)		
Taxable income	£18,525	£15,000	£10,000

Tax	£
18,525 @ 20%	3,705
15,000 @ 20%	3,000
3,875 @ 10%	387
37,400	
6,125 @ 32½%	1,991
Tax liability	9,083
Less: Tax on interest (20%)	(3,000)
Tax on dividends (10%)	(1,000)
Tax due	**£5,083**

Illustration 2

Mr Coppel has the following taxable income in 2010/11

	£
Employment income	133,400
Interest (gross)	31,250
Dividends (gross)	22,222

Mr Coppel's tax liability will be calculated as follows:

Tax	£
£37,400 @ 20%	7,480
£96,000 @ 40%	38,400
£16,600 @ 40%	6,640
£14,650 @ 50%	7,325
£22,222 @ 42.5%	9,444
Tax liability	£69,289

4.3 Notional tax credit

The tax deducted from dividends is only a **notional tax** and **cannot be repaid.** The 10% credit may be used to reduce the tax liability, but only to nil. Any excess tax credits on dividend income will never be repaid, because these credits are only notional.

Illustration 3

A taxpayer has a tax liability, before credits, of £1,000. Tax deducted at source from the bank interest is £600 and the tax credits on dividends are £1,800. If we deduct the total tax credits of £2,400 from the tax liability, you will see that in principle the taxpayer is due a tax repayment of £1,400.

	£
Tax liability	1,000
Less: tax credits	(2,400)
Potential tax repayable	**£(1,400)**

However, if HMRC repay the full £1,400, they are repaying part of the tax that has been withheld on dividends. As this tax is only notional tax and is not repayable, the Revenue will restrict the tax repayment to any tax deducted from the bank interest. Therefore, in this example, the taxpayer will be entitled to a repayment of just £600.

When putting together the income tax calculation, personal allowances and any deductible payments are set first against non-savings income, thereafter against interest income and finally, any excess personal allowances and deductible payments can be deducted from dividend income. It is important to note that personal allowances and deductible payments are set off in that specific order and effectively go from left to right across your page.

When considering the availability of a tax credit on dividend income, the amount of the tax credit that can be deducted in the computation, is 10% of the **taxable** dividend.

ITTOIA 2005, S.397

By **"taxable dividend"** we mean the amount of the dividend that is brought into charge to tax **after any personal allowances or deductible payments have been deducted.**

Illustration 4

A taxpayer received employment income of £5,000 in 2010/11. His only other income is UK dividends of £36,000.

His tax due will be calculated as follows:

	Non Savings	*Dividends*
	£	£
Employment income	5,000	
UK dividends		
(£36,000 x $\frac{100}{90}$)		40,000
Less: Personal allowance	(5,000)	(1,475)
Taxable income	Nil	£38,525

Tax	
37,400 @ 10%	3,740
1,125 @ 32½%	366
Tax liability	4,106
Less: Tax credits on taxable dividend	
(38,525 @ 10%)	(3,852)
Tax due	**£254**

Notice in this illustration that the taxable dividend is £38,525, after personal allowances, which means that the available tax credit is 10% of that figure, being £3,852. The available tax credit is not 10% of the actual gross dividend – i.e. it is not 10% of £40,000.

This particular technical point is only important if a taxpayer does not have sufficient non-savings income or sufficient interest income to utilise any personal allowances or deductible payments. Therefore it will only be taxpayers whose income comes mainly from dividends that will be affected by this point.

4.4 Foreign dividends

If an individual is resident and domiciled in the UK, he will be chargeable to UK tax on dividends received from non-UK resident companies.

The recipient will be **given a notional 10% credit** as for a UK dividend provided certain conditions are met. This will eliminate any additional tax for basic rate taxpayers and reduce the overall charge for a higher rate taxpayer.

ITTOIA 2005, s. 397 A

For example, if an individual receives a foreign dividend of £850 net of a foreign withholding tax of 15%, we initially gross up the dividend by multiplying the net dividend by 100 over 85 to take account of the foreign tax. This gives us a gross dividend of £1,000. Assuming the relevant conditions are met, we then gross up the £1,000 for the notional 10% tax credit. Multiplying the £1,000 by 100 over 90 gives us £1,111 which is the amount we enter in the income tax computation.

The 10% notional credit will be available where the company paying the dividend is resident in a country which has a double taxation agreement with the UK which contains a non-discrimination provision. This covers most countries you are likely to come across in an exam, for example, France, Germany, USA, South Africa. The notional credit is also available where the paying company is not resident in a qualifying country but the shareholder has **less than 10%** of the shares of the foreign company.

4.5 Stock dividends

ITTOIA 2005, s. 409

In order to maintain cash reserves, sometimes a company will offer the shareholder new shares in the company instead of a cash dividend. These "replacement" dividends are known as "stock dividends" (also called "scrip" dividends).

If an individual accepts new shares in place of the cash dividend, the individual is taxed on the dividend foregone – i.e. on the cash he would have received had he not chosen the stock alternative. This "pretend" dividend is thereafter treated as a "normal" dividend and is taxed at the appropriate dividend rates. The notional 10% tax credit applies.

4.6 "Enhanced" stock dividends

Under s.412 ITTOIA 2005, where the difference between the cash dividend alternative and the share capital's market value equals or exceeds 15% of that market value, then the shareholder is charged to income tax on the market value of the share capital and not the dividend alternative.

ITTOIA 2005, s.412(2)

Many companies offer "enhanced" stock dividends as an incentive for shareholders to take the new shares instead of the cash.

Illustration 5

Stephanie has 10,000 shares in PDQ plc. On 5 June 2010 the company announces a dividend of 10p per share.

PDQ plc also offers their shareholders a 1:20 stock alternative. The price of the shares in June 2010 was £2.50.

Stephanie therefore has 2 choices:

(i) Accept cash dividend

The cash dividend will be
10,000 x 10p = £1,000

or

(ii) *Take the stock alternative*

A "1:20" stock alternative means that Stephanie can take 1 new share for every 20 she holds i.e.

10,000 ÷ 20	=	500 new shares
The new shares are worth		
500 x £2.50	=	£1,250

Assuming Stephanie accepts the new shares "in lieu" of the cash, she will have accepted an "enhanced" stock dividend (the difference of £250 is more than 15% of the new shares market value i.e, 15% x 1,250 = £188).

Therefore, Stephanie is deemed to have received a net dividend of £1,250. This will be grossed up in her tax computation and thereafter taxed as a normal dividend.

The shareholder will also be taxed on the market value of the shares, instead of the cash dividend where the new shares are worth at least 15% less than the cash dividend. This is unusual as shareholders will rarely be tempted to accept new shares instead of a larger cash dividend.

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Example 1

Mr Field has the following income in 2010/11:

	£
Salary (PAYE £4,800)	25,000
Bank deposit interest (net)	16,000
UK dividends (net)	4,500

Calculate his tax due.

Example 2

Mr Glade has the following income in 2010/11:

	£
Salary (PAYE £40,000)	120,000
Bank deposit interest (net)	20,000
UK dividends (net)	20,000

Calculate his tax due.

Example 3

Mr Forest has shares in the following companies:

Wood plc	-	175,000 shares
Copse plc	-	64,000 shares
Sherwood plc	-	12,000 shares

The following dividends were announced in 2010/11:

(i) Wood plc - dividend of 9p per share with no stock alternative
(ii) Copse plc - dividend of 15p per share with a 1:16 stock alternative
(iii) Sherwood plc - dividend of 6p per share with a 1:80 stock alternative

The share prices at the date of the dividend announcements were as follows:

Wood plc	-	£5.00 per share
Copse plc	-	£5.00 per share
Sherwood plc	-	£5.00 per share

Mr Forest has no other income in the year apart from building society interest of £3,000.

Calculate his tax due/repayable for 2010/11.

Answer 1

	Non Savings	*Interest*	*Dividends*
	£	£	£
Earnings	25,000		
Bank interest			
(£16,000 x $\frac{100}{80}$)		20,000	
UK dividends			
(£4,500 x $\frac{100}{90}$)			5,000
Less: PA	(6,475)		
Taxable income	£18,525	£20,000	£5,000

Tax	£
18,525 @ 20%	3,705
18,875 @ 20%	3,775
37,400	
1,125 @ 40%	450
5,000 @ 32½%	1,625
Tax liability	9,555
Less: PAYE	(4,800)
Tax on interest	(4,000)
Tax on dividends	(500)
Tax due	**£255**

Answer 2

	Non Savings	*Interest*	*Dividends*
	£	£	£
Salary	120,000		
Bank interest			
(£20,000 x $\frac{100}{80}$)		25,000	
UK dividends			
(£20,000 x $\frac{100}{90}$)			22,222
Less: PA (reduced to nil)	-	-	-
Taxable income	£120,000	£25,000	£22,222

Tax	£
37,400 @ 20%	7,480
107,600 @ 40%	43,040
5,000 @ 32½%	1,625
150,000	
17,222 @ 42½%	7,319
Tax liability	59,464
Less: PAYE	(40,000)
Tax on interest	(5,000)
Tax on dividends	(2,222)
Tax due	**£12,242**

Answer 3

Analysis of cash/stock dividends

(i)	Wood plc	-	cash dividend		
			175,000 x 9p	=	£15,750
(ii)	Copse plc	-	cash dividend		
			64,000 x 15p	=	£9,600
			or		
			stock alternative		
			$\frac{64000}{16}$ x £5.00	=	£20,000

£20,000 is taxable as the difference between the cash dividend and the shares' market value (i.e. difference of £10,400 (£20,000 - £9,600) is greater than £3,000 being 15% of the shares' market value)

(iii)	Sherwood plc	-	cash dividend		
			12,000 x 6p	=	£720
			or		
			stock alternative		
			$\frac{12000}{80}$ x £5.00	=	£750

£720 is taxable as difference of £30 < 15% of shares' market value being £113.

Summary of net dividends:

	£
Wood plc	15,750
Copse plc	20,000
Sherwood plc	720
Total	£36,470

Income tax computation:

	Interest	*Dividends*
	£	£
Building Society interest		
(£3,000 x $\frac{100}{80}$)	3,750	
Dividends		
(£36,470 x $\frac{100}{90}$)		40,522
Less personal allowance	(3,750)	(2,725)
Taxable income	Nil	£37,797
Tax		£
£37,400 @ 10%		3,740
£397 @ 32½%		129
		3,869
Less tax credits		
Interest (£3,750 @ 20%)	750	
Dividends (£37,797 @ 10%) (Note)	3,780	
		(4,530)
Tax Repayable		£(661)

Note: credit on dividends restricted to 10% of taxable dividend.

The £661 is repayable as it is deemed to come from tax deducted on interest.