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Canada Life

The Effects of the Reduction in the Dividend Allowance

It was announced in the 2017 Spring budget that the tax-free dividend allowance, which was introduced at a level of £5,000 in 2016/17, will be reduced to £2,000 from April 2018. The tax rates on dividend income above the allowance remain at 7.5% for basic rate taxpayers, 32.5% for higher rate taxpayers and 38.1% for additional rate taxpayers.

What does this reduction mean for clients?

Currently a basic rate taxpayer could hold a portfolio of equities, assuming a 3% yield, of £166,667. From April 2018 this would need to reduce to £66,667 in order to remain within the dividend allowance.

If the basic rate taxpayer continued to hold the portfolio of £166,667 for the tax year 2018/19 they would have an extra £225 tax to pay (£3,000 x 7.5%). This increases to £975 for a higher rate taxpayer (£3,000 x 32.5%) and £1,143 for an additional rate taxpayer (£3,000 x 38.1%).

You might find yourself explaining to clients why they now pay more tax, when they are generating the same level of income. However, as the following case study shows, due to the changing tax bands a client might actually pay less tax.

Case Study 1

- Daphne has non-savings income of £40,000 and dividend income of £10,000.
- In 2017/18 Daphne's total income straddles the basic and higher rate tax bands (£45,000 higher rate threshold).
- All her non-savings income above the personal allowance (£11,500) falls within the basic rate band, leaving £5,000 of basic rate band.
- The dividend income sits on top with the first £5,000 being taxed at 0%. This uses up the rest of the basic rate band, meaning that the remaining £5,000 dividend income is taxed at 32.5%, resulting in a tax liability of £1,625.
- In 2018/19 her tax liability on the dividend income will reduce.
- From April 2018 the higher rate threshold will increase to £46,350.
- As in 2017/18 Daphne's non-savings income, above the personal allowance (£11,850), falls within the basic rate band, leaving £6,350 of basic rate band.
- The dividend income sits on top with the first £2,000 now being taxed at 0%. After the £2,000 dividend allowance there is still £4,350 of basic rate band left to use against the remaining dividend income.
- As such Daphne will now pay tax at 7.5% on £4,350 with the remainder £3,650 being taxed at 32.5%.
- In the tax year 2018/19 Daphne will have a tax liability of (£4,350 x 7.5%) + (£3,650 x 32.5%) = £1,512.50, a tax reduction of £112.50.

However, if Daphne was already a higher or additional rate taxpayer then the amount of tax she would pay for 2018/19 would increase.

Now, let's consider the situation where Daphne holds a bond and how a chargeable gain would interact with her non-savings and dividend income.

Case Study 2

- Daphne has non-savings income of £40,000 and dividend income of £10,000.
- In May 2018 she surrenders an international bond, which has been in force for five complete years, resulting in a chargeable gain of £20,000.
- The personal savings allowance has been used elsewhere.
- When a gain is realised from an international bond it is treated as 'savings income', so when calculating Daphne's tax liability this gain would sit between the non-savings income and dividend income.
- So, to determine the tax rate payable on Daphne's dividend income you add together the non-savings and savings income (£60,000), making Daphne a higher rate taxpayer.
- After the 0% dividend allowance, Daphne's tax liability on her dividend income would be (£10,000 - £2,000) x 32.5% = £2,600.
- The tax payable on her non-savings income would be (£40,000 - £11,850) x 20% = £5,630.
- When the chargeable gain is added to the non-savings income Daphne straddles two tax brackets, meaning top slicing relief will be of benefit.
- The top-sliced gain is £4,000 (£20,000/5).
- When this is added to Daphne's non-savings income she remains a basic rate taxpayer, so the tax liability on the full gain will be £20,000 x 20% = £4,000.
- Daphne's overall tax liability, for 2018/19, would be £2,600 + £5,630 + £4,000 = £12,230.

But what if Daphne had surrendered a UK bond, and realised the same chargeable gain?

Case Study 3

- Daphne has non-savings income of £40,000 and dividend income of £10,000.
- In May 2018 she surrenders a UK bond, which has been in force for five complete years, resulting in a chargeable gain of £20,000.
- The personal savings allowance has been used elsewhere.
- UK bond gains are treated as 'savings income' but because they carry a 20% tax credit they are treated as the highest part of Daphne's total income.
- Therefore the dividend income sits on top of the non-savings income meaning that, in 2018/19, part will be taxed at basic rate.
- The tax payable on her non-savings income would be (£40,000 - £11,850) x 20% = £5,630, leaving £6,350 basic rate band available (£34,500 - £28,150).

- The dividend income sits on top of the non-savings income with the first £2,000 being taxed at 0%.
- The tax liability on the dividend income is, therefore, £4,350 x 7.5% = £326.25 plus £3,650 x 32.5% = £1,186.25, giving an overall liability of £1,512.50 on the dividend income.
- When the chargeable gain is added to the non-savings income Daphne straddles two tax brackets, meaning top slicing relief will be of benefit.
- The top-sliced gain is £4,000 (£20,000/5).
- When this is added to Daphne's non-savings income she remains a basic rate taxpayer so has no further tax to pay on the gain.
- Daphne's overall tax liability for 2018/19 would be £5,630 + £1,512.50 = £7,142.50.

Ultimately it would be wrong to adopt a broad-brush approach to tax wrapper selection, which is dependent on each individual client's circumstances. In practice, it would probably be appropriate for clients to have holdings in a variety of tax wrappers so they could take advantage of whichever tax break is most appropriate – annual exemption, top-slicing or others – when they needed to cash-in investments.

Kim Jarvis is Technical Marketing Manager at Canada Life UK. Find out more about our range of bond solutions.

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