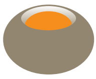

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The tax-free dividend allowance – what options do clients have?

One of the most noteworthy changes for next year is the reduction in the tax-free dividend allowance from £5,000 to £2,000 affecting shareholders and investors with significant portfolios.

The change is effective from April 2018, leaving advisers and their clients some time to organise their dividend income to shield it as much as possible from increased tax charges.

What's the tax-free dividend allowance?

The tax-free dividend allowance was only introduced with effect from 6 April 2016, and is still a new measure for tax planning. The allowance means clients do not pay tax on the first £5,000 of dividend income, no matter what non-dividend income a person has.

People should pay tax on dividends in excess of £5,000:

Taxpayer band	Dividend tax rate
Basic rate	7.5%
Higher rate	32.5%
Additional rate	38.1%

What's the impact of the cut?

From April 2018, this tax-free dividend allowance will be cut from £5,000 to £2,000. This will affect shareholder directors and investors with significant portfolios of typically more than £50,000. Many in this latter category are retired people who rely on their dividend income in retirement.

The effect of the cut will be more people may have to pay more tax on their dividend income.

Individual with £5,000 dividend income		
Taxpayer band	2017/18 – £5,000 allowance	2018/19 – £2,000 allowance
Basic	£0	£225
Higher	£0	£975
Additional	£0	£1,143

Furthermore, by cutting the allowance there's a danger shareholders who do not hold their stocks in an Isa or pension may be pushed further up into a higher tax bracket.

What options do clients have?

Clients and their financial advisers can explore several options to reduce their dividend income tax bill from 2018/19.

1. Using the tax-free dividend allowance

Clients will continue to have a £2,000 tax-free dividend allowance, which means they will be able to hold £50,000 in stocks yielding 4% before having to pay any tax on dividend income.

Or they may want to consider moving their highest yielding stocks into Isas or pensions (see below), while keeping the lower dividend yielding stocks outside the Isa. If the dividend yield on these stocks is less than 2%, then clients could hold £100,000 before they would breach the £2,000 dividend allowance.

Remember, taxable dividends are still more tax-efficient than taxable salary. Where company owners need income to meet day-to-day expenses, it may still be advisable to take dividend income rather than a salary, but just extract more to meet needs.

2. Using Isas

Clients should consider using Isas to shield their dividend income as they offer tax-free income and growth.

By acting before the end of the tax year, clients can shield up to £40,000 in a stocks and shares Isa by the time the new allowance comes into force:

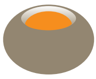
- £20,000 in 2017/18
- £20,000 on first day of the tax year, 6 April 2018.

Clients may want to consider selling existing share holdings and reinvesting the proceeds in an Isa using the 'bed and Isa' rules. However, this may give rise to a capital gains tax charge, although this could be covered (or partially covered) by the individual's £11,300 capital gains tax annual exemption.

Another way to increase Isa holdings is to consider using both of a couple's allowances – which could mean investing up to £80,000 over two tax years.

However, when deciding whether to use Isas to shield dividend income, clients need to be aware that Isas, unlike direct share holdings, cannot be placed into trust for IHT planning. Instead, when the client dies the Isa will remain within the estate for the purposes of IHT.

This is in sharp contrast with the situation for pension investments, which, on death of the client, will usually be deemed outside the estate for IHT purposes.



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3. Using pensions

In a similar way to Isas, clients could use pensions to shield dividend growth.

Clients can usually invest up to £40,000 a year (the current annual allowance) in pensions unless:

- they earn more than £150,000, when their annual allowance will be reduced gradually down to £10,000 (for those who earn more than £210,000); or
- they have 'flexibly accessed' their benefits (usually taken income from a flexi-access drawdown plan or an UFPLS (uncrystallised funds pension lump sum)) which triggers the money purchase annual allowance (MPAA) of £4,000 (2017/18).

Again, the client may choose to sell existing share holdings and reinvest these in a Sipp, or to make an in-specie contribution into the Sipp, but this will mean triggering a disposal for capital gains tax.

Any pension investment means the client benefits from tax relief on the contributions at their current marginal rate. However, they will be unable to access their investment until age 55, and then they can withdraw 25% tax-free, but will have to pay tax at their marginal rate on the remainder. However, clients can work with their advisers to manage this tax charge and reduce it wherever possible.

Pensions may also be a useful alternative to extracting profits as dividend income. If the director or shareholder doesn't need to use the extracted profits for day-to-day living, then they could consider paying the profits as an employer pension contribution instead. This factor – coupled with the flexibility introduced by pensions freedom – could lead to some business owners reconsidering their remuneration strategy.

4. Switching investment objectives

As shown above, clients should be able to work with their advisers to shield considerable amounts from the dividend tax by using the tax-free dividend allowance, Isas and pensions. However, for any shareholdings that can't be shielded in this way, clients could consider switching their investment profile, moving from an emphasis on generating income to one centred on capital appreciation. Again, this will reduce their dividend income tax liability, but may store up future capital gains tax charges unless planning is undertaken to counter this.

5. Gifting shares

Finally, the client could consider reducing their dividend tax exposure by gifting part of their shareholdings to someone else, for example, a spouse or a civil partner to ensure the couple can benefit from two lots of tax-free dividend allowances. If the client and their spouse or civil partner are living together this won't give rise to a capital gains tax liability. However, their spouse or civil partner may have to pay tax on any gain if they later sell the shares. The gain or loss will be worked out from when the client first owned the shares.

Our thoughts

The tax rules for shareholders have been changing fast. It is only a year since the government significantly altered the tax position by scrapping the dividend tax credit and introducing a 7.5% basic dividend tax rate and the £5,000 dividend allowance. And now this allowance has been more than halved. It's easy to see why some think the government is targeting shareholders to increase tax revenue.

These quick-fire changes send out a confused message to those trying to save for their futures. It makes it even more difficult to set a long-term plan, and could also have the knock-on effect of hitting confidence in markets. But it also flags up the need for shareholders to work with their advisers to make sure their investment portfolio is tax efficient. Tax is not the only consideration when setting the right portfolio, but it is an important one.

If you only read one thing read this

- The tax-free dividend allowance is being reduced from £5,000 to £2,000 with effect from 6 April 2018. Shareholders or those with significant portfolios will see an increase in the tax they have to pay on dividend income.
- Those affected can explore different options to reduce their tax liability on dividend income. As well as using their tax-free divided allowance, clients could use Isas, pensions, or investment bonds to shield dividend income.
- They could also consider switching the investment intention of their shareholdings from generating income to capital appreciation.
- These changes to tax rules for shareholders make it even more difficult to set a long-term plan. Advisers and their clients need to work together to make sure clients' investment portfolios are tax efficient.

Scotland, NI and north west England 0131 226 9815

North east and south east 0131 226 9808

Midlands, south west and Wales 0131 226 9804

London and south 0131 226 9801

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