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# The new regime for dividends and interest

From 6 April 2016, new dividend and savings allowances are introduced together with revised rates of taxation on dividends. In a changing landscape for personal tax, it is crucial to understand the opportunities and pitfalls in the new regime.

## What is the new regime?

### Dividend income

When dividends are received by an individual on or after 6 April 2016 the amount received is the gross amount subject to tax, with the previous 10% tax credit now having been abolished. In addition, a Dividend Allowance (DA) means that the first £5,000 of dividends are charged to tax at 0%. Dividends received above this allowance are taxed at the following rates:

- 7.5% for basic rate taxpayers
- 32.5% for higher rate taxpayers
- 38.1% for additional rate taxpayers.

Dividends within the allowance still count towards an individual's basic or higher rate band and so may affect the rate of tax paid on dividends above the £5,000 allowance.

Dividends are treated as the top slice of income. So personal allowances and the basic rate tax band are first allocated against other income.

### Example

Mr A has non-dividend income of £40,000 and receives dividends of £9,000. The non-dividend income is taxed first. Of the £40,000 non-dividend income, £11,000 is covered by the Personal Allowance, leaving £29,000 to be taxed at the basic rate.

The basic rate band for 2016/17 is £32,000 so this leaves £3,000 of dividend income that is within the basic rate limit before the higher rate threshold is crossed. The DA covers the £3,000, leaving £2,000 of the DA to be used for the dividends in the higher rate band.

The remaining £4,000 of dividends fall in the higher rate tax band and are therefore taxed at 32.5%.

### Savings income

For 2016/17 some individuals qualify for a 0% starting rate of tax on savings income up to £5,000. However this rate is not available if non-savings income (broadly earnings, pensions, trading profits and property income) exceeds the starting rate limit.

A new Savings Allowance (SA) is available from 2016/17 onwards, with savings income within the SA taxed at 0%.

The amount of SA depends on the individual's marginal rate of tax. An individual taxed at the basic rate of tax has an SA of £1,000 whereas a higher rate taxpayer is entitled to an SA of £500. Additional rate taxpayers receive no SA.

Savings income includes:

- interest on bank and building society accounts
- interest on accounts with credit unions or National Savings and Investments
- interest distributions from authorised unit trusts, open-ended investment companies (OEICs) and investment trusts
- income from government or corporate bonds
- most types of purchased life annuity payments.

### Is savings income received net or gross of tax?

This is much more complicated than you may think.

The introduction of the SA will mean that the majority of taxpayers will not pay tax on their savings income. The government has therefore removed the requirement (from 6 April 2016) for banks and building societies to deduct tax from account interest they pay to customers.

Some types of interest have always been received without tax deduction at source and will therefore continue to be paid gross. Interest on corporate bonds listed on the London Stock Exchange is paid gross for example. However, in 2016/17 basic rate tax will still be deducted at source from some forms of savings income such as interest distributions from unit trusts and OEICs. The government proposes to remove this requirement from April 2017.



## Maximising your entitlement to the allowances

There are winners and losers from the new dividend regime but the Chancellor stated in his budget speech that "85% of those who receive dividends will see no change or be better off". How do the changes impact on different levels of taxpayers?

A basic rate taxpayer with dividend income up to £5,000 is no worse off with the new DA but any dividends received above this level lead to a higher tax charge as prior to April 2016 their tax liability was covered by the dividend tax credit.

For higher and additional taxpayers, there is an initial tax benefit for dividends over £5,000 but as dividends increase there is a higher level of tax than under the previous rules. The tipping point for a higher rate taxpayer occurs when dividends received reach £21,666, as past this amount the new regime results in a higher tax charge. For additional rate taxpayers, the same principle is true but the amount at which the change occurs is £25,400.

Given the lower amount of SA, higher and additional rate taxpayers could seek to maximise their use of the DA by moving investments out of interest bearing investments to ones which pay out dividends. This could be through direct shareholdings or through dividend distributing equity funds in unit trusts or OEICs.

In addition, assets held for capital growth could be transferred to dividend paying investments. Any gains realised by the investors on the sale of assets would be exempt up to the CGT exemption which is £11,100 for 2016/17. Further gains over this amount are only charged to tax at 20% for higher and additional rate taxpayers now that the CGT rates have been reduced in the 2016 Budget.

## Pitfalls in the new regime

### Interaction between DA and SA

If the amount of dividends an individual receives is covered by the DA but those dividends would have meant that they were higher rate taxpayers without the DA, then this would affect the amount of SA they would receive.

#### Example

Mrs B has a salary of £42,000, interest income of £1,000 and dividends of £5,000. Although the dividends are covered by the DA, Mrs B's total income is £48,000 so she is a higher rate taxpayer. She would therefore only receive £500 of SA against the £1,000 of interest income.

## Maximising interest could come at a cost

Taxpayers may be seeking high interest rates to maximise the use of the savings allowance. However, the savings allowance is a cliff-edge test, so if interest income on savings takes a taxpayer into the higher rate band the amount of the allowance will reduce to £500 and similarly will fall to nil for additional rate taxpayers.

#### Example

In 2016/17, Mr C has non-savings income of £42,000 and savings of £40,000 on which he is earning 2.5% per annum. The interest income is therefore £1,000, giving total income of £43,000. As he is a basic rate taxpayer the whole £1,000 will be tax free.

If Mr C managed to get a higher rate of 2.7% on his savings, the interest would then be £1,080, taking his overall income to £43,080. As a higher rate taxpayer, only £500 of the interest would be tax free. Of the remaining £580, £500 would be taxed at 20% and £80 at 40% giving a tax charge of £132. The additional interest income carries a 165% tax charge!

## Check your coding

Where savings income exceeds the SA, there will be tax to pay on the excess. HMRC have indicated that they will normally collect this tax by changing individual's tax codes. To allow them to do this they will use information from banks and building societies. However in some cases

	Amount (£)
Your tax-free allowances	12,206
Gift Aid payments	0
Personal pension relief	0
Untaxed interest on savings and investment	-3,000
Car benefit for WSS Ltd	-7,137
<b>Change</b>	<b>-7,137</b>

HMRC have been overestimating the amount of interest people are likely to earn and adjusting their coding accordingly. So it is worth checking coding notices when they come through.

## Gift Aid donations

The new allowances could also affect taxpayers who make Gift Aid

donations. A charity can reclaim the tax on a Gift Aid donation only if the individual has paid the amount of tax being reclaimed. Prior to April 2016 this would also have included dividend tax credits and tax deducted at source on interest income.

With the introduction of the SA and DA, any income within these allowances is not taxed so the tax reclaim by the charity does not relate to tax paid. Where this happens the individual is responsible for ensuring that the donation is covered and HMRC have powers to recover any shortfall from the taxpayer.

So people with lower levels of income and dividends or savings below the DA or SA amounts who make Gift Aid donations could be affected. Individuals will need to withdraw any Gift Aid declarations that they have made to ensure that they do not get hit with a tax bill.

## Planning for spouses

The new regime may also mean it is time to look at the allocation of investments between husband and wives or civil partners. If just one partner has investments generating dividends or savings it could be beneficial to transfer part of the investments to the other partner to ensure they receive income which utilises their DA or SA. Any transfer of assets between husbands and wives or between civil partners who are living together can be made without any capital gains tax being charged.

With savings rates generally being at about 1.5% - 2% utilising the £1,000 basic rate SA would mean having interest earning assets of between £50,000 and £66,667. For dividends, assuming an average yield of 3%, the investment level would be £166,667 to fully utilise the £5,000 DA.

## What about ISAs?

ISAs are not affected by the above changes so any dividends or interest arising on investments within an ISA remain tax free. Although the total amount an investor can save in an ISA is currently £15,240 this amount will increase to £20,000 from April 2017.

## Conclusion

With more allowances available to taxpayers it is important to make sure full use is being made of the tax free amounts. There are a number of areas in this briefing where you may need specific advice depending on the circumstances so please do not hesitate to contact us.

