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INVESTING TAX-EFFICIENTLY

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Tax is getting more complex

The way that investments are taxed has changed over recent years as successive governments have chosen to handle various sources of investment income in different ways. The aim has typically been to increase tax revenues.

Alongside this, the whole tax system has grown increasingly elaborate, thanks to revenue-raising tweaks such as the taxation of child benefit and multiple reforms of dividend taxation. The situation was highlighted in a recent paper on savings tax from the government's own Office of Tax Simplification. This noted that, "the interactions between the rates and allowances is sufficiently complex at the margins that HMRC's self-assessment computer software has sometimes failed to get it right".

This guide offers a brief outline of how your investments are taxed. Expert advice is necessary if you require more information or a greater insight into how to cut your tax bill.

Taxing your investment income

Income from investments is generally taxed less than earnings, because there is no liability to national insurance contributions (NICs). However, investment income, other than from property, is always treated as the top slice of your income, with dividends usually first, followed by interest. The order is important in determining what rate of tax applies to specific incomes.

PLANNING POINT

Take expert advice if you require more information or a greater insight into how to cut that tax bill.

In 2016/17, a new personal savings allowance was introduced at the rate of £1,000 for basic rate taxpayers and £500 for higher rate taxpayers (based on UK tax bands, including Scottish residents). Both basic and higher rate taxpayers can save up to £200 tax on savings income (primarily interest), but there is no allowance for additional rate taxpayers.

The dividend allowance has been reduced to £2,000 for 2018/19. Above the dividend allowance, the effective rate of tax on dividends has increased by 7.5% over the 2015/16 rates.

Both the dividend allowance and savings allowance behave like nil rate tax bands. As a result, each allowance applies to the lowest tier of relevant income and that income is considered in the assessment of your total income, for example, in determining whether you are liable to pay higher rate tax. The result is a further complication in the rules for tax calculations.

Interest income

Interest from UK deposits is no longer paid net of basic rate (20%) tax because of the introduction of the personal savings allowance.

Deposits with offshore banks, such as those in the Channel Islands, also normally pay interest with no tax deducted. But the income is taxable in the UK if you are domiciled here and will need to be reported to HM Revenue & Customs (HMRC). If you do not report overseas interest to HMRC, there is a good chance that the bank or deposit-taker will have to report it under the new global Common Reporting Standard which comes into full effect from September 2018.

The ending of deduction of basic rate tax at source was designed to make life simple for most taxpayers, who would otherwise have had to reclaim small amounts of tax because their interest would fall within the newly introduced personal savings allowance. However, if your interest income exceeds your personal savings allowance, matters become more complicated:

- You can allow HMRC to collect the estimated tax due by adjusting your Pay As You Earn (PAYE) code, if you have one. However, this will use historic data. For example, in calculating your 2018/19 PAYE code HMRC will take account of interest you earned in 2016/17.
- Alternatively, on your self-assessment tax return you can request that estimated tax is not collected, in which case your liability will fall within the usual self-assessment payment procedure. This means payment will be made later than under the PAYE coding route, but you might face a large one-off demand.

Interest from directly owned, fixed-interest securities, such as government bonds (gilts), is usually paid without deduction of tax and you must report it to HMRC. When the nominal value of all your direct holdings exceeds £5,000, you will have to adjust after sale and purchase for any interest you have accrued.

If you invest in fixed-interest securities through a UK-based unit trust or open-ended investment company (OEIC), the income payments you receive are now made without deduction of tax.

Dividend income

The tax treatment of dividend income from shares, and funds that invest in shares, has grown more complicated over the years, and the tax rates have become divorced from the rates that apply to other income. In 2016/17 there was an overhaul, mainly aimed at discouraging incorporation by small businesses. For 2018/19 a further change has been made, with the same target of incorporation, but this time catching many more ordinary investors. As the table below shows, many recipients of modest dividend income will not pay more tax in 2018/19 than 2015/16. However, the cut to the dividend allowance means those with high dividend income could see over £1,000 added to their tax bill in 2018/19.

PLANNING POINT

When the nominal value of all your direct holdings exceeds £5,000, you will have to adjust after sale and purchase for any interest you have accrued.

Winners and losers from the 2016/17 and 2018/19 dividend tax rule changes

Tax rate (Dividend rate)	Dividend tax higher than in 2015/16 if dividends exceed		Maximum extra tax in 2018/19 due to dividend allowance
	2016/17 & 2017/18	2018/19	
Basic (7.5%)	£5,000	£2,000	£225
Higher (32.5%)	£21,667	£8,667	£975
Additional (38.1%)	£25,250	£10,100	£1,143

Dividends from UK companies, unit trusts and OEICs are tax-free up to your dividend allowance of £2,000, regardless of your personal tax rate. Beyond the allowance, rates are as shown in the table below.

Dividend taxation above the dividend allowance in 2018/19

Tax rate	Nil £	Basic £	Higher £	Additional £
Dividend	100.00	100.00	100.00	100.00
Tax due (rate)	Nil (0%)	7.50 (7.5%)	32.50 (32.5%)	38.10 (38.1%)

An advantage of dividend income that is often overlooked is that each £1 net income represents a smaller amount of gross income than either interest or earnings.

Example – Dividend taxation

Bill is a higher rate (40%) taxpayer who exhausts his dividend allowance when he receives a dividend cheque for £100. As the table above shows, he will have an extra tax liability of £32.50 leaving him with a net income of £67.50. Bill's gross dividend income from this payment will be £100. To achieve the same net income from an interest-paying investment would require gross interest of £112.50 (£112.50 x (100%-40%) = £67.50). The lower gross income result can be important because of the various tax thresholds that take gross income into account (e.g. pension annual allowance tapering).

PLANNING POINT

There are no longer any tax credits attached to dividend payments, so you must pay the full rate.

Property income

You will generally receive income from direct investment in property, such as buy-to-let, with no deduction of tax. There are extensive rules about what expenses you can offset against rents to determine how much of your income is subject to tax. Until the beginning of the 2017/18 tax year, the most important rule for many private investors was that they could offset the interest paid on borrowing to purchase residential property. This meant there was often little or no tax to pay, because the rent less expenses (e.g. agents' fees) was roughly the same amount as mortgage interest.

This tax regime is now part way through a process of change which started in 2017/18. Over four years, the maximum rate of relief on interest costs is being gradually converted to a basic rate tax credit, which effectively halves the amount of tax relief available to higher rate taxpayers from 2020/21. The move to a tax credit approach also means an increase in total income for tax purposes, which might trigger more tax payments (e.g. because the personal allowance phasing-out threshold of £100,000 is crossed).

Certain types of property income are subject to additional rules, such as furnished holiday lets, distributions from real estate investment trusts (REITs) and property authorised investment funds (PAIFs).

Life assurance-linked investment bonds

The tax treatment of single premium life assurance investment bonds often causes confusion, not least because profits are described as 'chargeable gains', but also because they are actually taxable as miscellaneous income. The basic tax regime can be summarised as follows:

- **The 5% rule:** For each of the first 20 policy years after payment of a premium, there is a credit of 5%, which you can offset against any amount you withdraw. To the extent that if you do not use the credit, it is carried forward to following years. If your withdrawals exceed the accumulated credit in a year, the excess is treated as income at the end of the policy year.
- **Full surrender and death:** When a policy ends because of a full surrender or the death of the last life assured, there is a 'sweeping up' calculation. The taxable gain in the tax year of death/surrender is then calculated as the total payments from the bond less all premiums paid in. You also deduct any earlier taxable excesses. This calculation brings any payments that have previously benefited from the 5% rule into tax.
- **Tax rate(s):** Gains are treated as the top part of your income (above dividends). For UK investment bonds, a basic rate tax credit (at 20%) is allowed, reflecting the fact that the insurance company has paid tax on the income and gains. Offshore policies are effectively free of UK tax on the underlying income and gains, and therefore do not benefit from the basic rate credit on encashment when the full income tax rates apply (including the starting rate band at 0% and the personal savings allowance).
- **Top slicing:** If the addition of policy gains pushes you into higher or additional rate income tax, top slicing relief can reduce your liability by treating the gain as spread over a period of years, which in most cases will be the time you have held the investment.

You should always seek advice before withdrawing any money from investment bonds, because the government has recently made a technical reform in this complex area. Their structure – for example, one bond could be 1,000 individual policies – can create serious tax traps.

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Example – Investment bond tax calculation

Brian arranged a £10,000 UK investment bond in August 2008. He took £500 withdrawals each year in January, starting in 2009. These were within the 5% rule and gave no rise to an immediate tax charge. In July 2018 he surrenders the bond for £9,850. The final chargeable gain on the bond is calculated as:

Surrender proceeds:	£9,850
Total withdrawals: 10 x £500	£5,000
Total policy proceeds	£14,850
Less	
Previous chargeable gains:	nil
Total invested	(£10,000)
	(£10,000)
Chargeable gain on surrender	£4,850

As Brian has total income of around £60,000, he is a higher rate taxpayer and will have to pay 20% tax (40% – 20% basic rate credit) on the gain, giving him a tax bill of £970. Top slicing relief (over nine years) does not affect Brian, because he is a long way from the starting point of the additional rate band.

Capital gains

In most circumstances, capital gains are taxed more lightly than your income, particularly if your net realised gains fall within the annual exempt amount (£11,700 in 2018/19) or you are a higher or additional rate taxpayer. Not all investments are subject to capital gains tax (CGT). For example, gilts and most other fixed-interest securities are exempt, but unit trusts and OEICs that invest in them are not.

The basic principles of CGT are now:

- Most disposals of investments – gifts as well as sales – trigger the need for a CGT calculation. Transfers to your spouse or civil partner are effectively ignored, provided you are living together.
- Gains and losses are calculated simply as the net proceeds less the total acquisition costs.
- Gains and losses you realise in the same tax year are netted off each other. If any losses are unused, you can carry them forward indefinitely until you need to use them. In general, you must claim the loss within four years of the tax year in which it arose.
- The annual exempt amount allows you to realise £11,700 in 2018/19 of net gains free of CGT. The allowance normally rises annually in line with consumer price index (CPI) inflation.
- If your net gains in a tax year exceed both your annual exempt amount and any carried forward losses you have available, the excess is added to your income. CGT is charged at 10% where your gains fall below the higher and additional rate bands and 20% otherwise. The two exceptions are gains from residential property and carried interest, where rates are 8% higher. In all instances, the CGT rate is comfortably below higher or additional rate income tax.
- Any potential CGT liability on unrealised gains is usually extinguished on death.

There are many ways of reducing the burden of tax on your investments, but you should always take professional advice before acting.

Example – Capital gains and capital losses

Florence is a higher rate taxpayer and she needs to realise some of her investments in the first half of 2019 to top up the Bank of Mum and Dad. She is thinking of selling an oil company shareholding that has an unrealised gain of £14,000 and disposing of some utility shares, which are showing a loss of £8,000.

- If she sells all her holdings in 2018/19, her net gain will be £6,000 (£14,000 - £8,000) and she will have no capital gains tax to pay because of her £11,700 annual exempt amount. However, the £5,700 of unused exemption cannot be carried forward to 2019/20 and will be lost.
- Alternatively, she could sell all the oil company shareholding and enough of the utility shares (about 29% of her holding) to realise a £2,300 loss. Her net gain would then match her full annual exemption (£14,000 - £2,300 = £11,700) and she would still have unrealised losses of £5,700 she could use by selling the remaining utility shares after 2018/19 ends.

Easing the investment tax burden

There are many ways of reducing the burden of tax on your investments, but you should always take professional advice before acting.

- **Stocks and shares individual savings accounts (ISAs)** offer freedom from CGT, and freedom from UK tax liability on interest from fixed-interest securities and on dividends. Interest on cash is free of UK tax in all ISAs.
- **Cash ISAs** provide deposits with tax-free interest.
- **Lifetime ISAs (LISAs)** offer the same tax advantages as other ISAs, with the added benefit of a 25% government bonus on savings. However, eligibility is limited to those aged 18-39 and there are penalties on withdrawal before the age of 60 unless funds are used to purchase a first home.
- **Onshore collective funds,** such as unit trusts and OEICs, can be useful in CGT planning because changes to the underlying portfolio do not give rise to any immediate tax liability for the investor.
- **Offshore collective funds** can offer some shelter from income tax, but at the cost of all gains being taxed as income.
- **Pension arrangements** have a wide variety of tax benefits, including full income tax relief on contributions. Within a pension plan there is no UK liability to tax on income or gains, and 25% of the accumulated fund is currently free of any tax after you have reached age 55, whether the whole value is taken as a lump sum or the remaining 75% is used to provide retirement income.
- **Life assurance-based investments** may save tax if you are a higher or additional rate taxpayer, or if you are a basic rate taxpayer with substantial dividend income.
- **National Savings & Investments** used to offer a wide range of tax-free investment products. However, at the time of writing its tax-free range is limited to a cash ISA, a cash JISA and Premium Bonds, although they hardly count as an investment.

How we can help

We can help with your investment tax planning in several ways:

- Selecting the most appropriate tax 'wrapper' for your chosen investments.
- Advising you on the most effective tax strategies for drawing income and/or capital from your holdings.
- Assisting you in calculations for your tax return.
- Keeping you up to date with the opportunities and dangers created by inevitable changes to investment tax legislation.

Information is based on our current understanding of taxation legislation and regulations.

Levels and bases of, and reliefs from, taxation can change and the value of tax reliefs depends on your individual circumstances. The Financial Conduct Authority (FCA) does not regulate tax advice.

Estate planning, trust planning and will writing is not regulated by the FCA.

The value of investments and income from them may go down.

Past performance is not a reliable indicator of future performance and you may not get back the full amount you invested. Investing in shares should be regarded as a long-term investment and should fit in with your overall attitude to risk and financial circumstances.

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