



KEY GUIDE

The taxation of investments



Increasing complexity

The taxation of investments has never been a simple matter. In recent years it has become more complex as successive governments have chosen to tax different sources of investment income in different ways, mostly with the aim of adding to the Exchequer's coffers.

On top of this, the whole tax system has grown increasingly elaborate, thanks to revenue-raising tweaks such the taxation of child benefit and the reform of dividend taxation.

This guide can give only 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 that tax bill.

Taxing your investment income

Income from investments is generally taxed more lightly 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 at the pinnacle, followed by interest. The order is important in determining what rate of tax is applied to the specific income.



Action point

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In 2016/17 a new personal savings allowance has been introduced at the rate of £1,000 for basic rate taxpayers and £500 for higher rate taxpayers. Both groups of taxpayers will save up to £200 tax on savings income (primarily interest), but there is no allowance for additional rate taxpayers. At the same time a new dividend allowance of £5,000 has been introduced for all taxpayers. Above the new allowance, the effective rate of tax on dividends has increased by 7.5% over the 2015/16 rate.

Both the dividend allowance and savings allowance operate more like nil rate tax bands. As a result, each allowance applies to the lowest tier of relevant income and that income is still taken into account for assessing your total income, for example, in determining whether you are liable to higher rate tax. The result is a further complication in the tax calculations rules.

Tax allowances, bands and rates in 2016/17

| | Property | Interest | Dividends |
|----------------------------------|------------|---------------------|--------------|
| | £ | £ | £ |
| Allowance | Nil | 1,000/500/0* | 5,000 |
| Tax bands above allowance | % | % | % |
| £0–£5,000* | 20 | 0 | 7.5 |
| £5,000–£32,000 | 20 | 20 | 7.5 |
| £32,000–£150,000 | 40 | 40 | 32.5 |
| £150,000+ | 45 | 45 | 38.1 |

**Personal savings allowance is £1,000 for basic rate taxpayers, £500 for higher rate taxpayers and nil for additional rate tax payers*

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 as recent publicity has made all too clear, the income is still taxable in the UK if you are domiciled here; it will therefore 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.

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 PAYE code (if you have one). In many instances HMRC has already done this for 2016/17, but based on the interest declared on your 2014/15 tax return.
- 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 make adjustments after sale and purchase to take account of interest you have accrued.



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If you invest in fixed-interest securities through a UK-based unit trust or open-ended investment company (OEIC), the income payments you receive will be net of basic rate tax, which you can reclaim if necessary. From 2017/18 interest paid by such funds also cease to have tax deducted at source and be made gross.

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. For 2016/17 there has been another overhaul, mainly aimed at discouraging incorporation by small businesses. As the table below shows, most recipients of dividends will not pay more tax in 2016/17 than 2015/16 because of this change

Dividends from UK companies, unit trusts and OEICs are tax free up to your dividend allowance of £5,000, regardless of your personal tax rate. Beyond the allowance, rates are as shown in the table below.

Winners and losers from the 2016/17 dividend tax rule change

| Marginal tax rate | Dividend tax higher in 2016/17 if dividend income exceeds |
|-------------------|---|
| Basic | £5,000 |
| Higher | £21,667 |
| Additional | £25,250 |

Dividend taxation above the dividend allowance in 2016/17

| 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%) |

There is no longer any 10% tax credit attaching to dividend payments, so you must pay the full rate.

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

Example – Dividend taxation

Bill is a higher rate taxpayer who has exhausted 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 net income of £67.50. Now that there is no dividend tax credit, Bill's gross dividend income will be £100. To achieve the same net income from an interest-paying investment would require gross interest of £112.50 ($£112.50 \times 0.6 = £67.50$). The lower gross income result can be important because of the various tax thresholds that take gross income into account (e.g. child benefit tax).



Action point

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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. For many private investors the most important rule is that, at present, they can generally offset the interest they pay on borrowing to purchase property. The result is that currently there may be little or no tax to pay because the rent less expenses (e.g. agents' fees) is often roughly equivalent to the amount of mortgage interest they need to pay.

However, over four years from 2017/18 the maximum rate of relief on interest costs will gradually be restricted to basic rate only, effectively halving the amount of tax relief available if you are a higher rate taxpayer. For 2016/17 the 10% wear and tear allowance for furnished lets has also been replaced with a less favourable allowance based on actual expenditure.

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 the following year(s). 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 of all payments made out of 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, from 2016/17, 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. Their structure – for example, one bond could be 1,000 individual policies – can create serious tax traps.

Advice is also necessary because the government has signalled that it intends to make reforms in this area, probably from 2017/18.



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Example – Investment bond tax calculation

Brian arranged a £10,000 UK investment bond in March 2007. He took £500 withdrawals each year in January, starting in 2008. These were within the 5% rule and gave no rise to an immediate tax charge. In February 2017 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 | <u>£5,000</u> |
| Total policy proceeds | £14,850 |
| Less | |
| Previous chargeable gains: | nil |
| Total invested | <u>(£10,000)</u> |
| | (£10,000) |
| Chargeable gain on surrender | <u>£4,850</u> |

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 (£11,100 in 2016/17) 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 £11,100 in 2016/17 of net gains free of CGT. The allowance normally rises annually in line with 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. Other than for residential property and carried interest, CGT is charged at 10% to the extent that your gains fall below the higher and additional rate bands and 20% otherwise. For the two exceptions, 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.



Action point

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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.
- **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.
- **Pension arrangements** have a wide variety of benefits, not the least of which is 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 the age of 55 years, whether the whole value is taken as a lump sum or the remaining 75% is used to provide retirement income.

- **Life assurance-based investments** Life assurance investment bonds may be able to help you 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, Children's Bonds 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 the 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 does not regulate tax advice.

Estate planning, trust planning and will writing is not regulated by the Financial Conduct Authority.

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.

This publication is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking any action on the basis of the contents of this publication. The Financial Conduct Authority (FCA) does not regulate tax advice, so it is outside the investment protection rules of the Financial Services and Markets Act and the Financial Services Compensation Scheme. This publication represents our understanding of law and HM Revenue & Customs practice and the Finance Bill 2016 draft clauses as at 30 June 2016.



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