HARTSFIELD
FINANCIAL SERVICES LIMITED
Wealth Management

The taxation of investments

Making the most of your money

KEY GUIDE

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 as the taxation of child benefit and the forthcoming 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.

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.

Focus point

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.

Tax bands and rates in 2015/16

	Property	Interest 2014-16	Dividends
£	%	%	%
0–5,000*	20	0	10
5,000–31,785	20	20	10
31,785–150,000	40	40	32.5
150,000+	45	45	37.5

**0% % rate only applies to interest if the band is not already covered by your earned and/or property income.*

In 2016/17 a new personal savings allowance will be introduced at the rate of £1,000 for basic rate taxpayers and £500 for higher rate taxpayers. This will mean both groups of taxpayers will save up to £200 tax on savings income (primarily interest). There will be no allowance for additional rate taxpayers. At the same time a new dividend allowance of £5,000 will be introduced for all taxpayers, although it would be more accurate to describe this as a nil rate tax band for dividends. Above the new allowance, the effective rate of tax on dividends will increase by 7.5%.

Interest income

Interest from UK deposits is usually paid net of basic rate (20%) tax, but with the introduction of the personal savings allowance next tax year, automatic deduction of tax will stop. Some National Savings & Investments products, such as income bonds, already pay interest without tax deducted at source, but the income remains fully taxable.

Deposits with offshore banks, such as those in the Channel Islands, 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 the interest to HMRC, there is a good chance that the bank or deposit-taker will have to.

The current deduction of basic rate tax at source makes life simple for basic rate taxpayers, but if you do not pay tax at the basic rate, matters become more complicated.

- If you are a non-taxpayer, you can request any UK bank or building society to pay interest gross by completing HMRC form R85 (available at www.gov.uk/government/publications/income-tax-get-interest-without-tax-taken-off-r85-from-6-april-2015). You will need a form for each account. NS&I investments, including Pensioner Bonds, are not covered by this arrangement: a tax reclaim is necessary.
- If you are a taxpayer, but the tax deducted on your interest exceeds your liability, you will have to reclaim tax from HMRC. This can happen if your total income means you are a basic rate taxpayer in 2015/16. In such circumstances you can normally make your claim by using HMRC form R40 (available at www.gov.uk/government/publications/income-tax-claim-for-repayment-of-tax-deducted-from-savings-and-investments-r40).
- If you are a higher or additional rate taxpayer, you will have to pay extra tax on your interest. This may be collected through your self-assessment return or by an adjustment to your PAYE coding.

Focus point

While the deduction of basic rate tax at source makes life simple for basic rate taxpayers, if you are not paying tax at the basic rate matters become more complicated.

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.

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.

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. From 2016/17 there will another overhaul of dividend taxation, full details of which are still awaited.

Dividend taxation in 2015/16

Tax rate	Nil £	Basic £	Higher £	Additional £
Dividend	90.00	90.00	90.00	90.00
Tax credit	10.00	10.00	10.00	10.00
Gross dividend	100.00	100.00	100.00	100.00
Tax liability	Nil	10.00	32.50	37.50
Tax credit	(10.00)	(10.00)	(10.00)	(10.00)
Extra tax due	Nil*	Nil	22.50	27.50

**No reclaim possible*

Dividends from UK companies, unit trusts and OEICs are currently paid net, with an attaching 10% tax credit that will match your tax liability if you are a basic rate taxpayer. If you are a higher or additional rate taxpayer, there will be further tax to pay. If you are a non-taxpayer, you cannot reclaim the 10% tax credit.

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.

For example, Bill is a higher rate taxpayer and receives a dividend cheque for £90, as the table shows. He will have an extra tax liability over and above the tax credit of £22.50 leaving him with net income of £67.50. For tax purposes Bill's gross dividend income will be £100 (£90 + the 10% tax credit). To achieve the same net income from an interest-paying investment would require gross interest of £112.50 (£112.50 x 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).

From 2016/17, the dividend tax credit will be scrapped and all taxpayers will be entitled to a £5,000 dividend allowance. As a result you will have no tax to pay on the first £5,000 of your dividend income, regardless of your marginal tax rate on other income. Beyond the £5,000 (which is taken into account for total income purposes), new rates will apply, as shown in the table below.

Focus point

Within a pension plan there is no UK liability to tax on income or gains.

Dividend taxation above the dividend allowance in 2016/17

Tax rate	Nil £	Basic £	Higher £	Additional £
Dividend	90.00	90.00	90.00	90.00
Tax due (rate)	Nil (0%)	6.75 (7.5%)	29.25 (32.5%)	34.29 (38.1%)

**Net payment – The tax credit is abolished from 6 April 2016*

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 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 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 of you are a higher rate taxpayer. From 2016/17 the 10% wear and tear allowance for furnished lets will also be 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.

Investment bond tax calculation

Brian arranged a £10,000 UK investment bond in March 2006. He took £500 withdrawals each year in January, starting in 2007. These were within the 5% rule and gave no rise to an immediate tax charge. In February 2016 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.

Focus point

The rules applying to the taxation of capital gains have changed significantly in recent years.

- **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.

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 2015/16) 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 2015/16 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. CGT is charged at 18% to the extent that your gains fall below the higher and additional rate bands. Otherwise the tax rate is 28% – comfortably below the rate applicable to income subject to 40% or 45% tax.
- Any potential CGT liability on unrealised gains is usually extinguished on death.

Focus point

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

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 higher or additional rate tax on dividends (the 10% tax credit cannot be reclaimed). Interest on cash is now 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 tax 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 you can normally take up to 25% of the accumulated fund as a lump sum, currently free of any tax after you have reached the age of 55 years.

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.

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.

HARTSFIELD
FINANCIAL SERVICES LIMITED

Wealth Management

The taxation of investments
Making the most of your money

HEAD OFFICE
Hartham Park, Corsham,
Wiltshire SN13 0RP

Tel: 0800 612 6633
Email: enquiries@hartsfield.co.uk
www.hartsfield.co.uk