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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 (and re-form) 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.

Action point

Take expert advice 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.

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. These figures are unchanged in 2017/18.

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. A new dividend allowance of £5,000 was also introduced in 2016/17 for all taxpayers. It, too, is unchanged for 2017/18, but will probably be reduced to £2,000 from 2018/19. Above the dividend allowance, the effective rate of tax on dividends was 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.

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. However, the income is still taxable in the UK if you are domiciled here and 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 2017/18, but based on the interest declared on your 2015/16 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.

Action point

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.

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 in 2017/18 are now made without deduction of tax. For 2016/17 and earlier years, interest was paid net of basic rate 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 another overhaul, mainly aimed at discouraging incorporation by small businesses. From 2018/19 a further change is likely to apply, with the same target of incorporation, but this time catching more ordinary investors. As the table below shows, most recipients of dividends will not pay more tax in 2017/18 than 2015/16 because of the introduction of the dividend allowance. Much of this gain would be lost when the allowance is cut by 60% to £2,000 in 2018/19 as is still expected.

Dividends from UK companies, unit trusts and OEICs are tax free up to your dividend allowance of £5,000 (£2,000 from 2018/19), regardless of your personal tax rate. Beyond the allowance, rates are as shown in the table below.

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

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

Dividend taxation above the dividend allowance in 2017/18 and 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%)

**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 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).

Action point

There is no longer any 10% tax credit attaching 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. 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 a basic rate tax credit only, effectively halving the amount of tax relief available if you are a higher rate taxpayer. The move to a tax credit approach will also mean an increase in total income for tax purposes, which might trigger more tax payments, e.g. because the personal allowance phasing-out 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 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 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 is making a technical reform in this area, although it is unclear when this will now take effect.

Action point

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Example – Investment bond tax calculation

Brian arranged a £10,000 UK investment bond in March 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 February 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 (£11,300 in 2017/18) 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 £11,300 in 2017/18 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

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 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 subscriptions. However, eligibility is limited to those aged 18-39 and there are penalties on withdrawal before age 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 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 and taxed at your marginal rate.
- **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.

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