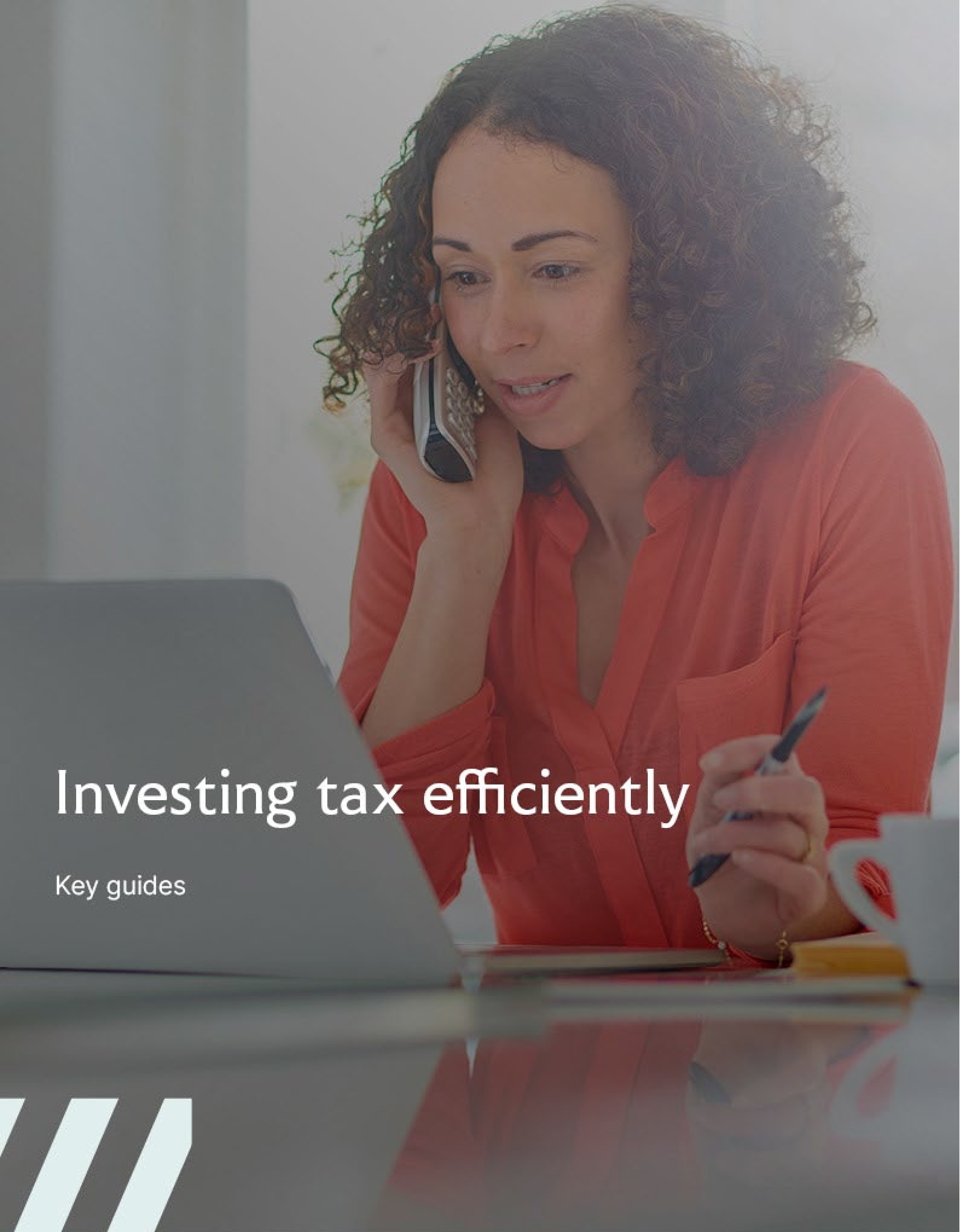

Investing tax efficiently

Key guides

WREN STERLING

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Introduction

The complex world of tax on investment

The UK tax system has grown increasingly elaborate, thanks to revenue-raising tweaks such as the freezing of many elements and multiple reforms of dividend taxation. With more changes possible in coming years from the new government – even after the Autumn Budget tax rises – the complexities are only likely to increase.

This guide offers a brief outline of how your investments are *currently* taxed and future changes (or freezes) that have *already* been announced, including those set out in the Autumn Budget. The Covid-19 pandemic hit government finances hard and ever since, successive Chancellors (and their Scottish counterparts) have been taking significant steps to raise revenue. As a result:

- Many personal tax allowances and bands are now frozen until April 2028, despite inflation having peaked at over 11% in October 2022, in the first tax year of the freeze.
- There was a six-percentage point jump in the main rate of corporation tax from April 2023.
- Since April 2023, the starting point for additional rate tax (top rate in Scotland) has been £125,140, nearly £25,000 below the previous (frozen) level.
- In Scotland a further 1% was added to the higher and top rates from 2023/24 and another 1% to the top rate in 2024/25, taking them to 42% and 48%. Scotland also saw the introduction of a new 45% 'advanced rate' of tax for income between £75,000 and £125,400 in 2024/25.
- The taxation of dividends is now much less generous than when the current structure was introduced in 2016/17.
- Following the Autumn Budget 2024, the tax burden is on course to reach to 38.2% of GDP by 2029/30, its highest since 1948 and over five percentage points above the pre-pandemic figure.

Expert advice is necessary if you require more information or a greater insight into how to cut your share of the growing tax burden.

Please note that all examples included in this guide are fictitious.

How your investment income is taxed

Income from investments is generally taxed less than earnings because there is no liability to national insurance contributions (NICs). While there have been several proposals for income tax and NICs to be combined and for the newly merged tax to be applied to *all* income, reform looks unlikely in the near term.

For now, 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.

The personal savings allowance (PSA) was introduced in 2016/17 at levels that have been unchanged since 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 Bank of England bank rate was 0.5% when the PSA was introduced, a fraction of the 4.75% bank rate reached in November 2024. Consequently, many more savers are likely to pay tax on their interest income in 2024/25 than in 2016/17.

The dividend allowance was also introduced in 2016/17, at the rate of £5,000 for all taxpayers, but was reduced to £2,000 in 2018/19. For 2023/24 it was halved to £1,000 and in 2024/25 it has been halved again to just £500. Above the dividend allowance, the effective rate of tax on dividends is at least 8.75%.

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.

Many investments can be purchased in ISA tax wrappers, which can shield your money from certain taxes. ISAs will probably make up a key element of your investment plan. Investors do not pay any personal tax on income or gains, but ISAs may suffer unrecoverable tax on foreign income from stocks and shares.

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

Interest income

Interest from UK deposits is paid with no deduction for 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). Even if you do not report overseas interest to HMRC, there is a good chance that the bank or deposit-taker will report it under the global Common Reporting Standard requirements. In a recent statistical release, HMRC revealed it had received over seven million foreign financial account reports in 2018.

The payment of interest without any tax deduction 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 personal savings allowance. However, if your interest income exceeds your personal savings allowance – more likely now than in earlier years – 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 2024/25 PAYE code HMRC will have taken account of interest you earned in 2022/23. With interest rates in April 2022 below 1%, that figure may represent an underestimate, leaving you with a tax bill after the tax year ends.
- Alternatively, if you file a 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.

If interest on a fixed-term savings bond is automatically accumulated and there is no option to withdraw it (as applies, for example, with some National Savings & Investments products), HMRC's view is that there is no tax due during the life of the bond, but *all* interest is taxable at the maturity date.

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.

Income payments from fixed-interest securities through a UK-based unit trust or open-ended investment company (OEIC) are made without deduction of tax.

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.

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. Since 2016/17 there have been a number of changes to dividend and corporate taxation, not all favourable to investors.

Dividends from UK companies, unit trusts and OEICs are tax-free up to your dividend allowance of £500 in 2024/25 (and 2025/26), regardless of your personal tax rate. Beyond the allowance, rates are as shown in the table below.

Dividend taxation above the dividend allowance

Tax rate	Nil £	Basic £	Higher £	Additional £
Dividend	100.00	100.00	100.00	100.00
Tax due (rate)	Nil (0%)	8.75 (8.75%)	33.75(33.75%)	39.35(39.35%)

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 in England who has no remaining dividend allowance when he receives a dividend cheque for £100. As the table above shows, he will have an extra tax liability of £33.75 leaving him with a net income of £66.25. 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 £110.42 (£110.42 x (100%-40%) = £66.25). The lower gross income result can be important because of the various fixed tax thresholds that take gross income into account (e.g. pension annual allowance tapering).

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.

There is no mortgage interest offset allowed against rental income for personally owned residential property. Instead, a basic rate tax credit is given for interest paid. This effectively means that the amount of tax relief available to higher rate taxpayers is half what it used to be when full offset was allowed. That result has become painfully obvious as interest rates – and hence mortgage costs – have risen. Some buy-to-let investors have found that their net property income disappears completely after their fixed rate mortgage has been refinanced at the end of its term at today's higher interest rates.

The tax credit approach has meant 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). The interest tax change has also encouraged some buy-to-let investors to place their properties in companies rather than own them directly.

Certain types of property income are subject to additional rules, such as distributions from real estate investment trusts (REITs) and property authorised investment funds (PAIFs). The special treatment that applies to furnished holiday lets will be withdrawn from 2025/26.

Planning point
A change to the rules on the treatment of mortgage interest now means that there is no interest offset allowed against rental income.

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. To summarise the basic tax regime:

- **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. 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 of the complexities that abound in their taxation treatment. Their structure – for example, one bond could be 1,000 individual policies – can create serious tax traps.

Example – Investment bond tax calculation

Brian arranged a £10,000 UK investment bond in July 2014. He took £500 withdrawals each year in October, starting in 2014. These were within the 5% rule and gave no rise to an immediate tax charge. In June 2024 he surrendered 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.

Planning point
Investment bonds generally require a lump-sum investment of at least £5,000 and you should expect to have your money tied up for at least five years.

Capital gains implications

In most circumstances, capital gains are currently taxed more lightly than income, particularly if your net realised gains fall within the annual exempt amount (£3,000 in 2024/25) 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.

Following several changes in the Autumn Budget 2024, 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 value realised 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 £3,000 of net gains free of CGT in 2024/25 (and 2025/26).
- 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. For gains realised after 29 October 2024, CGT is charged at 18% where your gains fall below the higher rate band and 24% otherwise. The upper CGT rate is thus comfortably below higher or additional rate income tax.
- Any potential CGT liability on unrealised gains is usually extinguished on death.

- CGT is normally payable by 31 January in the tax year after the gain is realised, e.g. 31 January 2026 for gains realised in 2024/25.

There are three important points relating to CGT on residential property which taxpayers need to remember to factor in:

- Any CGT on residential property gains became due within 60 days of sale completion, along with a tax return.
- The CGT exemption for a main residence now has a normal maximum extension period of just nine months after moving out.
- Rules for lettings relief limit eligibility to those instances where the property owner shares occupation with the tenant.

Planning point
You should think about the timing when disposing of any chargeable assets, as you may be able to take advantage of spreading gains or losses across different tax years.

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 2025 to top up the Bank of Mum and Dad. She is thinking of selling an oil company shareholding that has an unrealised gain of £7,000 and disposing of some bank shares, which are showing a loss of £6,000.

- If she sells all her holdings in 2024/25, her net gain will be £1,000 (£7,000 - £6,000) and she will have no capital gains tax to pay because of her annual exempt amount. However, the £2,000 of unused exemption cannot be carried forward to 2025/26 and will be lost.
- Alternatively, she could sell all the oil company shareholding and enough of the bank shares (two thirds of her holding) to realise a £4,000 loss. Her net gain would then match her full annual exemption (£7,000 - £4,000 = £3,000) and she would still have unrealised losses of £2,000 she could use by selling the remaining bank shares after the 2024/25 tax year ends. Preserving those losses is more important now, given the much-reduced level of the annual exemption.

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. If, however, you incur a government withdrawal charge (currently 25%) you may get back less than the value you paid into a LISA.

- **Onshore collective funds**, such as unit trusts and OEICs, can be useful in CGT planning because changes to the underlying fund do not give rise to any immediate tax liability for the investor.
- **Non-reporting 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 (57 from April 2028), whether the whole value is taken as a lump sum or the remaining 75% is used to provide retirement income.
- **Life assurance-based investments,** both on- and offshore based, may save tax if you pay tax at more than basic rate, 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.

How we can help

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

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

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

Tax treatment varies according to individual circumstances and is subject to change.

The Financial Conduct Authority does not regulate tax advice.

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.

Investors do not pay any personal tax on income or gains, but ISAs may pay unrecoverable tax on income from stocks and shares received by the ISA managers.

Stocks and Shares ISAs invest in Corporate bonds; stocks and shares and other assets that fluctuate in value.

By saving in a Lifetime ISA instead of enrolling in, or contributing to an auto-enrolment pension scheme, occupational pension scheme, or personal pension scheme: (i) you may lose the benefit of contributions from your employer (if any) to that scheme; and (ii) your current and future entitlement to means tested benefits (if any) may be affected.

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 the Autumn Budget 2024 and law and HM Revenue & Customs practice as at 7 November 2024.