R03 Taxation of investments 2019/2020

This part will not cover the characteristics or risks of different products but will focus on their taxation in the hands of individual savers and investors. It will cover the taxation of.

- Directly held investments
- Collective investments such as unit trusts and OEICS
- Individual Savings Accounts
- Life policies and annuities
- EIS, SEIS & VCT
- Offshore products

Directly held investments

This covers the taxation of the four main asset classes when held directly by an investor.

- Cash deposits
- Gilts and Corporate Bonds
- Shares
- Property

Cash deposits

From 6 April 2016 all bank and building society accounts, together with National Savings products pay interest gross. In view of current low interest rates and the introduction of the PSA most savers will not have any tax to pay. Nevertheless, savings income is almost always taxable.

Investments outside the PSA and the 0% savings rate band are taxed at:

Basic rate	20%
Higher rate	40%
Additional rate	45%

Tax free interest can be received from:

- Individual Savings Accounts (dealt with later)
- National Savings Certificates
- National Savings Children's bonds

There are no **NS Certificates** currently on sale. Existing ones will continue to run and on maturity savers can elect to invest in a new issue, albeit at slightly worse terms.

National Savings Children's Bonds are no longer on sale and when current ones mature they cannot be renewed. They are free of income tax and exempt from the parental income rule, The maximum investment was £3,000 per child per issue with a term of five years.

Fixed Interest (Gilts and Corporate Bonds)

Interest is paid gross but liable to income tax at savings rates. As it is interest, the PSA and the 0% rate can be used

They are free of Capital Gains Tax but losses cannot be set off against other gains.

The purchase of Gilts and corporate bonds are exempt from stamp duty.

Shares (including Investment Trust Shares)

Dividends are paid gross. The rates are:

£2,000	0% (The dividend allowance)
Basic rate	7.5%
Higher	32.5%
Additional	38.1%

Gains are subject to CGT

Property

Individuals will usually directly invest in property through **buy to let**. Investors will pay income tax on the profits they make from renting the property and this will be classed as non-savings income. Property income (unless it is from furnished holiday lettings) is not classed as income from a "trade, profession or vocation" which means that any losses made in a tax year cannot be offset against profits in a later one. Neither can capital allowances be used so if a landlord buys furniture this cannot be offset against rental income. Accounts must also be drawn up on a year ending 31 March or April 5 basis.

Income tax on rental properties

The rules on this changed significantly in 2017/18 and will evolve further up until 2020/21. Landlords pay tax on the **profits**, they make rather than the rental income itself.

The profit is gross rental income less allowable expenses. These will include:

- Insurance, managing agent's fees.
- General maintenance but not improvements which can be offset against CGT

Prior to April 6 2016 landlords of furnished accommodation could deduct 10% of rental income as general wear and tear but only the costs of replacing furniture can now be deducted.

Prior to 2017/18 all the interest payable on a mortgage was an allowable expense. From the start of 2017/18 tax year tax relief on mortgage interest will start to be tapered and by 2020/21 will be a tax reducer at basic rate. For 2019/2020 tax relief is restricted to 25% of the mortgage interest. To illustrate the effect of this, the situation on one particular landlord will be considered.

> Gwen has a salary of £35,000 and has invested in two properties bringing in gross rents of £72,000. She pays £30,000 in mortgage interest and £12,000 on other allowable expenses.

In 2019/2020 she can only claim 25% of the rental income, £7,500, against tax. The other £22,500 will be given relief at 20% and as a tax reducer.

Salary		£35,000
Rental income	£72,000	
Less interest	(£7,500)	
Less expenses	(£12,000)	
	£52,500	£52,500
Total Income		£87,500
Less PA		£12,500
		£75,000
	£37,500 @ 20%	£7,500
	£37,500 @ 40%	£15,000
		£22,500
Less £22,500 @ 20%		£4,500
Tax liability		£18,000

By 20/21 she will not be able to offset any mortgage interest so her total income would be £35,000 + (£72,000 less £12,000) = £95,000.

Based on the current tax thresholds and PA her liability would be:

£37,500 @ 20% =	£7,500
£57,500 @ 40% =	£23,000
	£30,500
Less	
£30,000 @ 20%	£6,000
	£24,500

It might seem that a 20% rate tax payer will not be affected by these changes but this is not the case. The tax credit does not reduce an individual's income so not being able to deduct mortgage interest may put an individual into a higher tax bracket or result in them reaching the £100,000 point at which personal allowance is reduced.

The reduction in tax relief has increased interest in switching to a corporate structure where tax relief is still available. The advantages and disadvantages can be summarised as follows.

Advantages

- Mortgage interest can be offset against rental income.
- Corporation tax at 20% would be taxed on profits and capital gains.
- Capital gain can be reduced through indexation.
- Any dividends paid would benefit from the Dividend Allowance.

Disadvantages

- Switching from private holding would be a disposal for CGT.
- Dividends come from taxed profits.
- Greater costs for accountancy fees.
- May be more difficult for accompany to raise a mortgage

Capital Gains Tax is calculated in the normal way but the rate is 18% or 28%.

Other property investments

There are three special types of property investment that could be tested:

- Rent a room
- Holiday Lettings
- Property exemption

Rent a room scheme

Rent a room can only be used by a resident landlord, whether or not they own the home. It can also be used by a bed and breakfast or guest house owner. It cannot be used for homes converted into separate flats.

This relief lets individuals let out a room or rooms in their house. The scheme allows a tax free income of £7,500 per house per year. If the ownership is in joint names the allowance is split equally between the couple. The income can also include any amounts received for meals and services such as cleaning and laundry.

The tax exemption is automatic if the total income is less than £7,500. If the income is more the owner must complete a tax return and then opt into the scheme and claim the allowance. Any income over £7,500 will be taxed as the owner’s non-savings income.

If the scheme is used the landlord cannot offset any expenses against the rental income.

Theresa takes in paying guests into her home and in 2019/2020 she earns £12,500. She calculates her expenses are £4,000.
Opting into rent a room means that £5,000 of her income will be taxable (£12,500 less £7,500).
If she keeps to the "normal" basis £8,500 of her income will be taxable (£12,500 less £4,000)

To qualify the property:

- Must be part of the resident landlord's main home.
- must be in the UK
- must be let as a residence. A part that is let out as an office would not qualify. However, the scheme can be used if the lodger works at home in the evening or at the weekend or is a student who is provided with study facilities.
- The area let out cannot be a self-contained. It could not be claimed if there was a flat with its own separate entrance within the he house.
- must be furnished.

Holiday Lettings

The principle of the holiday lettings regime is that the property is let for a series of short term periods. Whilst it doesn't need to be in a holiday resort the lettings mimic the typical holiday pattern in that there is a high turnover of tenants. The principle benefit is that the profit is treated as trading income rather than property income.

To qualify the property:

- Must be in the European Economic Area
- Must be furnished and let on a commercial basis
- It must be available for 210 days a year
- It should be let for 105 days a year (if more than one property this can be averaged)
- It should not normally be let for more than 31 days at a time. Letting for longer than 31 days does not disqualify its holiday lettings status but any such let will not count towards the 105 day requirement

The tax benefits are:

- It is treated as a trade for the purposes of loss relief. Any losses can be offset against future profits from the same holiday lettings business but not other income.
- Capital Allowances can be used.
- It is considered as relevant earnings for pension contributions.
- If a property is sold and reinvested in another one, holdover relief on CGT applies.
- Entrepreneur relief is available

It is also possible that it may qualify for Business Property Relief. To get this the owner must be offering some additional services such as providing meals or arranging local excursions. There are no hard or fast rules so each case will be considered individually by HMRC.

<u>The £1,000 property exemption</u>

- If property **income** is less than £1,000 this is exempt from tax and does not need to be declared.
- This could include letting out a driveway for parking.
- If the income is higher than £1,000 an individual can offset £1,000 but cannot claim any other expenses.
- The election to take the £1,000 exemption can be taken on a year by year basis
- If the house is jointly owned both owners can have the full £1,000 exemption
- It cannot be combined with Rent a Room relief.

Collective Investments

Collective investments are investment trusts, unit trusts, OEICs and ETFs. The basic principle is that they follow the taxation of the underlying investment.

Gilt and Corporate Bond funds

The distributions from funds investing in Gilts and corporate bonds will be classed as savings income and will qualify for the Personal Savings Allowance and the 0% rate. Interest is now paid gross. Gilt and corporate bond funds are subject to CGT even though the underlying assets would be exempt if held directly.

Equity Funds

Distributions from equity funds are classed as dividend income. Like dividends these are now paid gross and taxed exactly the same way as directly held shares. They are subject to CGT.

The taxation of income from multi asset funds depends on its make-up. If more than 60% of its assets are in gilts/bonds then distributions will be classed as savings income. If less than it is classed as dividend income.

Property Funds

Most property funds are constructed either as a:

- Property Authorised Investment Fund (PAIF)
- Real Estate Investment Trust (REIT)

Gains on both are subject to CGT but the taxation of the income is slightly different. Before these structures were set up the rental income was taxed within the fund itself which was not tax efficient.

The income from a PAIF is split into three streams:

- Property Income Distributions (PID) which arises from the fund's property investment business
- Dividend Distributions. Any dividends received in the fund
- Interest distribution. Any interest received from the fund.

Property Income Distributions are paid net of 20% and are classed as non-savings. Dividend distributions are paid gross and taxed as dividend income. Interest distributions will be paid gross and taxed as savings income.

The income from a REIT is split into two streams:

- Tax exempt element which represents the rental income and taxed in the same way as the PID from a PAIF.
- Non-exempt element which represents the dividend income and taxed in the same way as the dividend distribution from a PAIF

Individual Savings Accounts

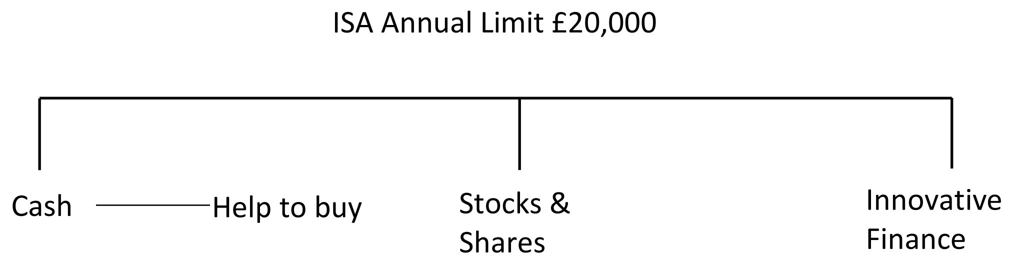
The range of Individual Savings Accounts and their flexibility has evolved since its introduction in the late 90's which means that there is more to learn!

The basic principle of an ISA is that it is a tax shelter which can be placed around different assets that results in the income and gains being tax free.

When the rules were changed on July 1 2014 the Government introduced the term New Individual Savings Account (NISA) but in many of their publications they still use ISA.

It may be best to consider the current situation as a "general" ISA with one subscription limit which can be put into different components. From April 6 2016 there is also the Lifetime ISA. Finally there is also a Junior ISA that has different subscription limit and rules.

Standard ISA New subscriptions



A standard or general ISA can contain the above components. Each is normally provided by different providers so banks and building societies tend to restrict themselves to the cash component. Investment companies will normally only offer the stocks and shares component. Investors can choose a different provider for subscriptions to each component in a tax year but they cannot split subscriptions for each component between different providers.

Subscriptions can either be made by new money being invested or, in the case of the stocks and shares component, by transferring non-ISA holdings.

Tom has about £50,000 in various unit trusts. In August 2016 he transfers £20,000 of these into an ISA which uses his maximum subscription for that year. He can repeat this in subsequent tax years.

In practice the investor would normally have to sell the unit trusts and repurchase the same assets into an ISA. This would be a disposal for CGT purposes.

Cash Component

The cash component gives interest free income and can be taken out by UK tax residents who is over 16 years old. A subset of the cash component is the Help to Buy ISA

Help to buy ISA

This is designed to assist first time buyers. It is a cash based ISA and can benefit from a 25% boost from the government. They are offered by banks and building societies who have signed up to the scheme.

The eligibility conditions are:

- 16 or over and be a UK tax resident
- Have a valid NI number.
- Be a first time buyer and not have another house anywhere in the world
- Not have another active cash ISA in the same tax year

To get the bonus the property that is being purchased must:

- Be in the UK
- Cost up to £250,000 or up to £450,000 if buying in London
- Not rented out after it is purchased
- Be purchased with a mortgage

The way it works is as follows:

- The account is opened with a bank or building society
- An initial deposit of up to £1,200 can be made.

- Monthly payments of up to £200 can then be made
- Once £1,600 has been saved it qualifies for the minimum government bonus of £400
- The bonus is £50 for every £200 that is saved with a maximum bonus of £3,000
- When the property is purchased the solicitor will apply for the bonus once the bank or building society is told that the account is being closed. The bonus can only be released once the property is purchased so cannot be used to fund a deposit.

As with a standard ISA a help to buy ISA can only be in individual names. This means that a couple can take out two Help to Buy ISA and potentially qualify for a government bonus of £6,000

The final date to take out a Help to Buy ISA is November 30 2019 but the bonus can be claimed up until December 1 2030.

Stocks and Shares component

These can include directly held shares and bonds together with unit trusts and OEIC investing in these. All interest and dividends are tax free.

To take out this component, individuals must be UK tax resident and over 18.

Innovative Finance component

This allows investors to use "Peer to Peer" lending platforms within the ISA. Whilst these became available from April 2016 few are currently on offer but are expected to increase.

ISA Post subscription

Withdrawals

Up until April 2016 if money or assets were withdrawn it lost its tax free status and could not be replaced. This changed from the 2016/17 tax year

Keith invested the full £20,000 in a cash ISA in May 2018. In August 2018 he withdraws £3,000. He can contribute £3,000 by the April 5 2018.

Rani invested £10,000 in an ISA and withdrew £1,000. She can contribute another £11,000 this tax year to take her up to the maximum subscription.

Providers aren't obliged to allow investors to do this so their conditions should be checked.

Transfers

It has always been the case that assets in one ISA can be transferred to another provider without losing its tax free status. It is also possible to transfer a cash ISA to an Equity ISA and vice versa. All providers must allow investors to transfer out but they are not obliged to allow transfers in.

Care must be taken that it is a transfer. If the ISA is closed the ISA wrapper is removed and only that year's unused subscription can be made.

Lu has £50,000 in an ISA. He decides to move all of it to a new provider. He instructs the provider to close the account rather than transfer it. As a result, the maximum that he can place into an ISA is £20,000 in the current tax year

The rules on how much can be transferred are different depending on whether the transfer relates to the current or previous year's contribution.

Ben invested the maximum £20,000 in August 2019. He also has an ISA with a value of £40,000 from contributions made in previous tax years.

If he wants to transfer the contribution made in August 2019 in tax year 19/20 he must transfer all of it. (any growth in the original subscription must also be transferred)

With the ISA from the previous year he can decide to transfer just part of it
After April 6 2020 he can transfer just part of the subscription made on 19/20.

Death

When an individual who owns an ISA dies, the executors can register it to be a **continuing ISA**. This maintains its tax free status whilst in the estate until it is distributed to one or more beneficiaries.

A surviving spouse or civil partner can also claim an **Additional Personal Subscription (APS).** If death occurred on or after 6 April 2018 this is the greater of the value of the ISA at date of death or the value when it was paid from the estate.

Tim had two funds in his ISA. On the date of his death, one fund had a value of £45,000 and the other £35,000

When the fund was distributed the first had increased in value to £46,000 and the other had fallen to £32,000

His spouse's APS would be £81,000 (£46,000 + £35,000)

If death had occurred before 6 April 2018 the APS would have been £80,000 (£45,000 + £35,000}

The other key rules on the APS are as follows.

- The underlying assets in the ISA can be passed on to someone else but the surviving spouse/CP will still get the APS.
- The recipient spouse has three years from date of death to use the APS. Or if the estate takes longer than three years to wind up, within 6 months of the date when the estate is would up.
- The surviving spouse can choose a different manager and funds from their spouse/CP but can only use one manager for the whole of the APS

Lifetime ISA (LISA)

The Lifetime ISA or LISA was introduced in April 2017. Many of the features are the same as general ISA but there are significant differences regarding:

- Maximum subscription.
- Eligibility
- Tax benefits.
- Taking withdrawals.

Maximum subscription

This is £4,000 which forms part of the overall £20,000 allowance. This can be made either by new money or by transferring funds from an existing ISA.

Eligibility

Apart from being a UK tax resident there is an age restriction. You must be at least 18 and be under 40 to open one but contributions can continue until age 50. If you are contributing to a help to buy ISA you cannot contribute to a LISA.

Individuals can only take out and contribute to one LISA per tax year but can have a different provider each year.

Tax breaks of a LISA

As with a standard ISA income and gains within the funds' investments are tax free. The proceeds are also tax free to the investor.

In addition, the Government will add 25% to the money invested whether it is new money or by transfer.

Frank contributes £1,000 to a LISA and gets a £250 bonus. Joe transfers £4,000 from a standard ISA into a LISA and gets £1,000 bonus.

Bonuses will still be added on contributions made between the investor's 40^{th} and 50^{th} birthday.

Taking withdrawals

Unlike the general ISA a LISA has two specific uses:

- To help fund a first-time house purchase.
- To fund retirement.

Investors do not need to designate its purpose at the outset and can change their plans.

Helen took out a LISA with the intention of using it to fund a first-time purchase. She then receives an inheritance and uses it to buy a house. She continues to fund the LISA to provide income in later life.

The fund can be accessed at any time but there will be a penalty of 25% of the amount withdrawn unless:

- The investor is terminally ill (expected life expectancy of less than 12 months)
- It meets the criteria for first time purchase.
- It is encashed after 60.

Gwyneth has contributed the maximum of £4,000 a year and in 20/21 the fund has a value of £24,000. She then withdraws £8,000 and a penalty of £2,000 is applied. Her fund now has a value of £14,000

Cancellation under the 30 day cooling off notice will not attract a penalty but no bonus will be added. Withdrawals by the LISA manager to pay fees and charges can also be made without attracting a penalty charge.

First time house purchase

The criteria are similar to a Help to Buy ISA. The purchaser must be

- 18 or over and be a UK tax resident
- Have a valid NI number.
- Be a first time buyer and not have another house anywhere in the world

To get the bonus the property that is being purchased must:

- Be in the UK
- Cost up to £450,000.
- Not rented out after it is purchased
- Be purchased with a mortgage

The LISA must have also been open for at least 12 months.

A criticism of the Help to Buy ISA was that the funds were only released after the purchase was completed. The LISA fund plus deposit can be used to provide an exchange deposit provided the purchase is completed within 90 days of the conveyancer receiving the funds from the LISA manager. If completion takes longer the conveyancer can ask for an extension.

The following table shows the main differences between the HTB ISA and the LISA

	HTB ISA	LISA
Eligibility	Minimum age 16, no maximum	18 to 40
Availability	Scheme ends 30 November 2019	No cut off date
Purpose	House purchase only	House purchase and/or retirement
Investment	Cash only	Cash/stocks and shares
Contribution	£200 a month plus £1,200 initial deposit	Maximum £4,000 a year
Bonus	25% of fund with a max of £3,000	25% of annual contribution from date started until age 50
Bonus paid	On completion	Monthly from April 2018
Maximum fund	£12,000 before addition of bonus	None. Only limited by years of contributions
Maximum property value	£450,000 London/£250,00 elsewhere	£450,000
Transfers from ISA	No	Yes
Penalties	None but if not used for house purchase, no bonus paid.	25% of amount withdrawn after 6 April 2018 if not used for house purchase and taken before age 60

Junior ISA (JISA) and Child Trust Fund (CTF)

- This is open to children aged under 18
- Before April 2016 if children qualified for a **Child Trust Fund (CTF)** they were ineligible for a JISA. However from April 6 2015 a CTF can be transferred into a JISA
- A CTF was available to children born between 1 September 2002 and 2 January 2011
- A Junior ISA can only be opened by a parent or legal guardian but other people may then contribute to it
- The maximum contribution to a JISA (and a CTF) is £4,368 for tax year 2019/20. Note that the JISA allowance is per tax year whereas the CTF is per plan year as the start date is the date of birth of the child.

- Unlike an adult ISA you can only have one provider (two if separate cash and equity) for the whole life of the plan
- Both have the same tax breaks as a standard ISA.
- Both can be in Investments or cash with no restrictions on the proportion held within each class
- In both cases there is no access to the fund until the child reaches 18. At that point it switches automatically into an adult ISA and becomes the child's property. The only exception to this is if the child dies or becomes terminally ill.
- One oddity of the ISA regime is that someone who is 16 or 17 can take out a cash ISA in their own name with a limit of £20,000 whilst their parents could also open up a JISA for them. This would give them a total ISA contribution limit of £24,368. If the money for the cash ISA (not the Junior ISA) comes from the parents any income above £100 will be treated as the parents

Insurance Policies

The taxation unit trusts and OEICS fall primarily on the investor. The underlying investments are deemed to be held on behalf of the investors who are responsible for paying tax on any income and gains.

In an insurance product, the assets are owned by the insurance company which is primarily responsible for paying any tax. Whether the investor has any further liability will depend on whether the policy is qualifying or non-qualifying.

- If the policy is qualifying the original policyholder will never be subject to personal tax on the proceeds. It cannot be called tax free as the company will have paid tax on the investments.
- If the policy is non-qualifying the policyholder may be subject to additional **income tax** on the gain.

The main non-qualifying plan is the Investment or Insurance Bond and is a favourite topic in all tax exams.

Investment/Insurance Bonds

- These are single premium (lump sum) investments.
- They are structured as a whole of life policy. It has no fixed term and will come to an end on the death of a named person. This is clear difference between life based and non-life based investments. A unit trust or an OEIC can be left to someone else on the investor's death. If the policy holder is the same as the life assured, the plan will come to an end on their death.
- Unlike a unit trust or OEIC and Investment Bond does not pay an income to the investor. The insurance company will receive income from the fund's assets and this will be reinvested in the fund thus increasing the unit price.
- The policyholder hopes that the price of the units will rise and encash the units to make a gain.

A range of funds is usually offered by the life company and these are unitised in the same way as a unit trust, that is, it is an open-ended fund but there are significant differences in taxation.

An Insurance Bond is taxed in the same way regardless of the type of fund. With a unit trust the taxation of a gilt based fund is different to an equity fund. In an Insurance Bond the tax treatment for the investor is the same.

Taxation

- The investor only becomes liable to tax when there is a **chargeable event.** There are a number of these but for the moment just one, a final encashment or surrender, will be considered to illustrate the principles.

Henry invested £50,000 in an Investment Bond on February 1 2009. On September 1 2019 he fully encashes the bond and receives £94,000, a gain of £44,000

The first point is that the £44,000 gain is subject to **Income Tax** and not CGT. The amount of tax, if any, will depend on Henry's tax status.

Gains under non-qualifying life policies are taxed after all other income so if Henry has an income of £50,000, the whole gain will be in the higher rate band. However as 20% tax is deemed to have been paid within the fund the rate he will pay is 20% rather than 40%.

His liability will be £44,000 x 20% = £8,800

Similarly, if his income was £160,000 the tax due would be 25% and his liability would be £11,000.

If Henry is a basic rate tax payer with an income of £35,000 it might seem that he has no further liability but this may not be the case. If the £44,000 is added to his income it would take him into the higher rate tax band but in these cases **top slicing** can be used. It works in this way.

The gain is divided by the **complete number of years** the bond has been in force.
In Henry's case this would be £44,000/10= £4,400
This is added to his other income to give £39,400.
This is still within the basic rate band so no tax is due.

If Henry's income was £48,000 the top slice of £4,400 means that £2,400 is within the higher rate tax band and thus becomes chargeable. The calculation will be as follows:

Multiply the amount in the higher rate band by the complete years the bond was held.
In this case, £2,400 x 10 = £24,000
This is chargeable at 20% to give a liability of £4,800

To summarise the key points:

- Top slicing is mainly used if the total gain takes a basic rate tax payer into higher rate tax.
- Divide the gain by the complete number of years the bond has been held
- Add this to the policyholder's other income.
- If all the top slice is within the basic rate band no tax is due.
- If part of the gain is in the higher rate band multiply this amount by the complete number of years the bond has been held.
- This is the chargeable amount and is taxed at 20%

Top slicing can also be used to prevent or mitigate a higher rate taxpayer being taxed at additional rate.

Cath has an income of £140,000 and a chargeable gain of £50,000 which she has had for 10 complete years. The top slice is £5,000 which added to her income is all within the higher rate band so her liability is £50,000 @ 20% = £10,000. Without top slicing it would have been £10,000 @ 20% + £40,000 @25%, a total of £12,000

Joint policies

Investment Bonds are often taken out in joint names, typically a husband and wife. In the event of a total surrender the gain is split 50/50 and taxed on an individual basis.

Tom and Geraldine surrender an Investment Bond and the gain is £50,000. Tom's share is £25,000 as is Geraldine's. Tom is a higher rate tax payer so has to pay £25,000 @ 20% = £5,000 Geraldine is a basic rate tax payer after applying the top slice to her income so she has no further tax liability

If Geraldine had no other income, £12,500 of this gain will be within her Personal Allowance. Unfortunately, the tax paid internally by the insurance company cannot be reclaimed.

Death

An Investment Bond is a life policy and when the life assured dies the policy will end. This is another Chargeable Event. The exact position on any tax liability will depend on how the policy was set up. This could be:

- Single planholder who is also the life assured.
- Joint planholders who are also the lives assured
- Single/joint planholders but with different life(s) assured.

In the first example when the planholder dies, the policy comes to an end and this will be a chargeable event. The liability will be calculated on the deceased's own circumstances as if they were still alive. The deceased's executors will complete a self-assessment form for the deceased and pay any tax from the estate.

A joint life case is almost always written on a second death basis. This means when the first life dies, there is no chargeable event and the policy becomes the sole owner. When that person dies the process is exactly the same as for a single life bond.

The life assured need not be the same person/people and this can be useful as it allows the plan to continue after the planholder(s) death.

Pete and Peggy take out an IB with their grandchildren as the lives assured. Pete dies first and this is not a chargeable event. Peggy becomes the sole owner. She dies five years later but her grandchildren are still alive so the Investment Bond continues. It becomes part of her estate and can be distributed according to her will. If the executors surrender the Bond that will be a chargeable event and the liability will fall on the executors. The rate will be 20% regardless of the size of the gain but as 20% tax is deemed to have been paid within the bond, no further tax is payable.

Assigning a bond

As an IB is a life policy it can be assigned from the planholder to another person who in turn can assign it to someone else. Assignment effectively transfers the right to claim the benefits to another person. Provided the assignment is a gift it is not a chargeable event. In the previous example the trustees could assign the bond to another person without creating a tax liability for themselves. It also means that the recipient receives the legacy as a fund rather than cash.

If in the previous example, Peggy's executors had decided to assign it to her daughter that would not be a chargeable event so no tax would be due. If her daughter decides to surrender it any tax would be calculated on her circumstances and for top slicing purposes we would use the date when the bond was originally taken out.

An assignment which is paid for is a chargeable event.

Income from an IB

Unlike a unit trust or an OEIC, an IB does not produce a separate income stream. Instead all income received by the insurance company (either as Gilt interest or dividends from shares) is reinvested in the fund which is then reflected in a higher unit price. It is possible to take an "income" from an IB but this is done by encashing units on a regular basis. The investor is therefore withdrawing capital.

The 5% rule

- It is possible to withdraw **5% of the original investment** without incurring an immediate tax charge. This can be withdrawn each **plan year**. A plan year starts on the day the plan is set up so the first plan year for an IB taken out on April 1 2017 will be April 1 2017 to March 31 2018. On April 20 2018 10% of the original investment can be withdrawn with no immediate tax liability even though the plan is just over a tear old.
- The 5% is cumulative so if it is not taken out one year it carries over to the next one. An initial investment of £10,000 in its 5th year means that 25% of the plan (£2,500) can be withdrawn without incurring an immediate tax liability.
- It is not tax free since when the plan is fully encashed, all the previous withdrawals have to be added to the gain to make the final tax calculation.

- IBs are always lump sum investments. If an investor wishes to make a further investment it is usually advisable to add the new money to the existing plan rather than set up a new one. This is because the original investment (on which the 5% withdrawal is based) is **the original investment plus the new money**

Here are some examples:

Alan invested £100K in an IB on February 1 2009 On March 1 2019 the policy is in its 11th year so up to 55% or £55K can be withdrawn without creating a tax charge.

Beth invested £100K in an IB on February 1 2009. On December 1 2011 the policy was in its 3rd year so she withdrew 15% or £15,000. On March 1 2019 the policy was in its 11th year and the maximum withdrawal is £55,000. As she has already used up 15% (£15,000) a further £40,000 can be withdrawn without creating a chargeable event.

Carol invested £100K in an IB on February 1 2009. On December 1 2012 the policy was in its 4th year and she withdrew £10,000. This was below the £20,000 that could have been withdrawn so there is no chargeable event. On March 1 2019 the policy was in its 11th year and the maximum withdrawal is £55,000. As she has already withdrawn £10,000 a further £45,000 can be withdrawn without creating a chargeable event.

As has been mentioned the withdrawal is tax deferred rather than being tax free. This means that when the bond is finally surrendered the withdrawals are added to the overall gain.

Rachel invested £80,000 into a bond and over the years withdrew £20,000 all of which was in the 5% limit.

On final encashment Rachel received £100,000. Her total gain for tax purposes is:

Final encashment	£100,000
Less initial investment	80,000
	20,000
Plus 5% withdrawals	20,000
	£40,000

Any liability on Rachel will then be calculated in the normal way.

If more than 5% is withdrawn the excess is a **chargeable event**. This means tax may be due on the excess withdrawal over 5%. However remember that this will normally only affect a higher rate tax payer.

Yves invested £100,000 in an IB and one year withdrew £40,000 which was £10,000 more than the 5% allowance.

£10,000 would have been a chargeable event and taxed in that plan year. The £30,000 that was within the 5% allowance would be added to the gain on final encashment.

Segmented policies

To give more flexibility most IBs are segmented, that is they are set up as clusters of small policies, say for £100 each.

Fiona invests £50,000 into an IB which is segmented into 500 policies each with an initial value of £100. Ten years later the whole plan has a value of £75,000 and each segment's value is £150.

Fiona decides to encash enough segments to give herself £15,000. She would surrender 100 segments £150 x 100 = £15,000

Chargeable event

As has been seen the investor's liability to tax only occurs when there is a chargeable event. The full list of these is as follows:

- Death
- Full surrender of either the whole policy or individual clusters.
- Assignment for money, that is someone pays to have the policy assigned to them.
- Withdrawal of more than allowed under the 5% rule.

One point to note is that **switching** is not a chargeable event. Most plans offer a range of funds and it is possible to have several funds in one plan. If the investor wants to switch from one fund to another it can be done without incurring a chargeable event.

Qualifying Life Policies

A qualifying policy means that the proceeds are free of any **individual tax liability**. It cannot be described as tax free since the investment fund will have been taxed.

Rules for a qualifying policy:

- It must be paid at least annually (e.g monthly, quarterly, six monthly or annually)
- The term must be at least 10 years
- The premiums in one year cannot be more than double that in any other year
- The premiums in any year must be at least $1/8^{th}$ of the total premiums payable
- For an endowment policy, the life cover must at least be 75% of the premiums payable. If the age of the life assured is over 55, the 75% figure is reduced by 2% for each year over 55. For a whole of life policy. For a whole of life policy it is 75% of premiums paid to 75.
- Annual premium must be less than £3,600

- A qualifying policy can become non-qualifying. The main reason that it is cancelled within the lesser of 10 years or ¾ of the term

The main type of qualifying policy is an **endowment policy**. This policy runs for a specific period (minimum 10 years) and pays out a sum at the end of the term or on earlier death. They can either be **unit linked** or **with profits**

Unit Linked

- There is a guaranteed death benefit
- Premiums buy units one fund or range of funds
- At any time the value of the policy is the number of units multiplied by the unit price
- There are usually quite high charges with this type of plan and it may be some years until the value of the plan is greater than the premiums paid
- They are sometimes marketed as **Maximum Investment Plans**

With profits

- The plan starts with a guaranteed sum assured
- This will be paid out at maturity or on earlier death
- An annual bonus may be added each year
- This increase the promised payment on death or maturity and once paid it cannot be withdrawn
- When the plan matures there may be a terminal bonus

All the benefits in a with profits policy are expressed as a promise to pay. They do not give an indication of the plan's current value. If the plan is surrendered the amount payable will be determined by the life company.

An alternative is to sell the with profits policy on the second-hand market. The attraction to the buyer is that they know that they are certain to get the sum assured plus declared bonuses if they maintain the policy to the end of the term
The new owner will be subject to **Capital Gains Tax** on the final gain. This is the maturity value less price paid and premiums paid by the new owner

Annuities

The main products are:

- Purchase life annuities
- Compulsory Purchase (Pension annuities)
- Immediate Needs annuities

Purchase life annuities

- Part of the income is deemed to be return of capital and no tax is chargeable on this.
- The remainder is treated as savings income with 20% deducted at source. This can be reclaimed by non-tax payers. Higher rate tax payers pay a further 20%, additional rate tax payers 25%

- As it is savings income the PSA can be used.

Compulsory Purchase annuities

- These are annuities bought with the proceeds of a money purchase pension
- All the income is taxable as non-savings income

Immediate Needs annuities

- These are annuities bought to pay for long term care.
- There is no income tax on the annuitant provided the income is paid directly to the care provider

Enterprise Investment Schemes/Small enterprise Investment Schemes/Venture Capital Trusts

These are all designed to enable new start-up companies to raise capital by giving significant tax breaks to investors.

Enterprise Investment Scheme

Investors can claim 30% on subscriptions for new shares in a qualifying EIS up to £1,000,000. This is increased to £2 million if invested in a Knowledge Intensive EIS. This is given as a tax reducer which means that the relief reduces the investor's income tax liability.

Dave has an income tax liability of £160,000. He invests £500,000 so the tax relief is £150,000. His income tax liability is reduced to £10,000

If he invested £600,000 the relief is £180,000 and his liability would go down to zero but he would not get a refund.

Tax relief will be clawed back if the shares are disposed of within three years. Transfers to spouse/civil partner are not counted as a disposal, neither is disposal on the death of the investor.

There is an element of backdating in that if the investor did not use all their allowance in the previous year, any remaining balance can be invested in the current year. This can be done at any time in the tax year.

They are free from CGT if held for three years

Investments in an EIS can also be used to defer CGT.

Ken has made a capital gain of £100,000. Assuming he can use his annual exemption this would result in a charge of £17,600 (£88,000 x 20%).

He invests £88,000 into an EIS so defers the CGT tax payment.

The gain becomes chargeable when the EIS shares are disposed.

This relief can be claimed on disposals made up to one year after the EIS shares were purchased and up to three years before.

A further benefit is that if a loss is made the investor has a choice of either of treating it as a loss for CGT or offsetting the loss against income.

Barry invests £200,000 into an EIS at a net cost of £140,000. Four years later he sells the shares for £10,000 so his loss is £130,000. His income for the year of loss is £600,000 so all the loss is relievable at 45%. This means his tax bill is reduced by £58,500

Seed Enterprise Investment Scheme (SEIS)

It is designed to attract start-up capital to new companies smaller than the typical EIS venture.

From a tax point of view:

- Contributions of up to £100,000 in a tax year that can be spread over a number of qualifying companies but a company cannot raise more than £150,000 via SEIS investment.
- Tax relief of 50% will be given again as a tax reducer but shares must be held for 3 years unless transferred to a spouse/civil partner or on the death of the investor.
- Gains will be free of CGT if shares held for three years.
- If the investor has a CGT liability on disposal of another asset 50% of this can become exempt if invested into a SEIS. For example, a higher rate tax payer has a £100,000 gain after annual exemption. This would give rise to a £20,000 liability. By investing the gain into a SEIS the CGT liability is reduced to £10,000. This is in addition to the £50,000 income tax relief so effectively it cost £40,000 to make a £100,000 investment.
- Loss relief is also available so if the company failed and the shares were worthless an investor who was a 45% tax payer could offset £50,000 (loss after tax relief) against income so saving £22,500. Put another way a £100,000 investment carries a maximum loss of £17,500. (£50,000 less £22,500 less £10,000 CGT saving)

Any dividends paid from an EIS or SEIS will be subject to income tax.

Both EIS and SEIS qualify for Business Property Relief at 100% if the shares are held for two years and 50% if held between one and two years.

Venture Capital Trusts (VCT)

This product is a collective investment set up as an investment trust that invests in small start-up ventures.

- The maximum contribution to new shares per tax year is £200,000 and 30% relief is given as a tax reducer.
- This is withdrawn if shares are disposed of within 5 years. (transfers to spouse/civil partner or on death are exempt.)
- They are exempt from CGT but there is no CGT deferral.

- Dividends are tax free.
- There is no Business Property Relief

Offshore Investments

There are two main ones that are likely to be tested:

- Offshore Bonds
- Offshore Funds

Offshore Bonds

- These are life insurance bonds set up outside the UK.
- There is no UK tax on the fund so the growth should be greater than an on shore bond.
- When a chargeable event occurs a UK resident will be liable for income tax. As no UK tax has been deducted additional rate tax payers will be subject to a 45% charge on the whole gain, higher rate tax payers subject to 40% on the whole gain, a basic rate tax payer 20%.
- Top slicing can be used but only to prevent the investor going into a higher rate tax bracket.

Offshore bonds can be useful for non-tax payers since the individual's personal allowance, the 0% savings rate and the PSA can absorb the gain.

Tom set up an offshore Investment Bond for his daughter shortly after she was born. In September 2019 when she is 18, he assigns sufficient segments to give her £15,000 to fund her first year at university. This produces a £8,000 gain

She has no other income so she has no additional liability as she can use her PA and she has no further liability. In fact based on 19/20 figures a gain of £18,500 (PA + £1,000 PSA + £5,000 0% band) could be made without incurring a tax liability.

If investors have been both resident and non-resident during the life of the bond, the gain can be time apportioned by dividing the number of days they were resident by number of day's policy has run. If top slicing is used the number of years that are used is reduced by the total number of years, the investor was non-resident.

Offshore funds

- These are usually OEICS set up outside the UK
- HMRC will grant reporting status if 85% of investment income is distributed as dividend (42.5% for commodity funds)
- They are then treated as an onshore unit trust or OEIC with dividends being taxed as UK based OEICs with the £5,000 Dividend Allowance available.
- Gains are subject to CGT and the annual exemption can be used.

- If reporting status is not given (or withdrawn) the gain on disposal is calculated using CGT principles.
- Annual exemption cannot be used.
- Gain is liable to income tax.