AF1 Taxation of Investments 2022/2023
Part 1 Overview

The next subject is the taxation of the main investment products available to UK investors.

Some of this has already been covered in the Income tax and Capital Gains Tax sections but we will now go into further detail.

The milestones for this part are to:

- Recap the taxation of the main investment classes.
- Understand the tax treatment of unit trusts and OEICS both on and offshore
- Understand the taxation of property funds, including Real Estate Investment Trusts

Taxation of the main asset classes

Cash

- Interest taxed as savings income. Starting rate and PSA is available.

Gilts and Bonds

- Interest taxed as savings income. Starting rate and PSA is available.
- Gains are exempt from CGT but losses cannot be offset against gains of other assets.

Shares

- Dividend taxed as dividend income. Dividend Allowance of £2,000 available
- Subject to CGT

Direct Property Investment (Buy to Let)

- Rental profits are taxed as non-savings
- Mortgage interest is offset as a tax reducer at basic rate
- Accounts must be drawn up on either tax year or April 1 to March 31 basis
- Cannot use capital allowances nor offset income losses against other income.
- Capital Gains taxed at 18% or 28%

In addition there are special rules property for Furnished Holiday Lettings ,Rent a Room Relief for “lodgers” and the £1,000 property exemption. (see Part 6 of Income Tax for further details)

Collective Investments: Unit Trusts and OEICS

The taxation of these follow the underlying asset.

<u>Gilt and Corporate Bond funds</u>

The distributions from funds investing in Gilts and corporate bonds will be classed as savings income and both the Personal Savings Allowance and the 0% starting rate can be used. Gilt and corporate bond funds are subject to CGT even though the underlying assets would be exempt if held directly.

<u>Equity Funds</u>

Distributions from equity funds are classed as dividend income. They are paid gross and taxed the same 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.

If an OEIC is located off shore, it is referred to as an offshore fund.

- 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. Investors can use the £2,000 dividend allowance then the rates are 7.5%, 32.5% and 38.1%
- Gains are subject to CGT and the annual exemption can be used.

- If reporting status is not given the gain on disposal is calculated using CGT principles.
- Annual exemption cannot be used.
- Gain is liable to income tax at non-savings rate and the dividend allowance cannot be used.

Property Funds

Most unit trusts, OEIC and life funds offer property funds. They offer investors the opportunity to invest modest sums and get wide diversification but there are disadvantages.

- They can be illiquid as their terms will usually allow the manager to suspend dealings or withhold payment on redemptions for up to six months in turbulent market conditions.
- It can be difficult to value property as any valuation will be an estimate until the property is sold.

The alternative is to invest in the shares of property companies. This solves the liquidity issue as the shares can be traded freely on the market. However, the rental income becomes part of the company's profits so the investor does not directly benefit this income stream.

To solve this problem many property funds are constructed either as a:

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

A PAIF is an open-ended fund whereas a REIT is closed ended.

- Gains for both are subject to CGT at the standard rates of 10%/20% but the taxation of the income is slightly different.
- Both can be held in an ISA

PAIF

There are three conditions for a fund to be eligible as a PAIF.

- It must operate property investment business
- It must report income in three streams
- It must not permit corporate bodies to hold more than 10% of the fund value.

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 classed as non-savings.
- It is paid with a deduction of 20% for income tax unless it is held within an ISA. This satisfies the liability for basic rate tax payers but higher and additional taxpayers will have a further 20% or 25% liability. Non tax payers can reclaim the tax that was deducted.
- Dividend distributions are paid gross and taxed as dividend income. £2,000 dividend allowance available
- Interest distributions will be paid gross and taxed as savings income. Starting rate and PSA available.

Real Estate Investment Trusts (REIT)

This is a close ended company whose shares are listed on the Stock Exchange.

To qualify for REIT status:

- At least 75% of a company's profits must come from property rental.
- At least 75% of the company's assets must be involved in the property rental business.
- At least 90% of the company's property rental income must be distributed to investors

REITs do not pay any corporation tax or capital gains tax on their property investments.

The income paid to investors is split into two streams (if not held within an ISA)

- 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

That concludes this part so you should now:

- Be able to recap the taxation of the main investment classes.
- Understand the tax treatment of unit trusts and OEICS both on and offshore
- Understand the taxation of property funds, including Real Estate Investment Trusts

Further reading

https://www.jameshay.co.uk/media/4986/paifs-factsheet.pdf

https://www.gov.uk/guidance/apply-to-be-a-uk-real-estate-investment-trust

https://reitcomparison.co.uk/ultimate-guide-to-reits