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Tax and your investments

Saving is the new trend so this briefing outlines the key characteristics of alternative investments for individuals. In particular, as nothing rankles more than being taxed on savings which have already been taxed as earnings, the main focus will distinguish the relevant income and capital taxation implications of each type of investment.

Investment planning

Any individual seeking to make investments needs a plan. To formulate an effective plan a number of personal factors need to be considered, as well as the characteristics of different types of investments. Personal factors will include matters such as your age and stage of life, attitude to risk, required investment period, income or capital needs, taxation position and the need for ready access to cash.

For example, John, who has just retired at 65 with a lump sum, is likely to be influenced by different factors compared to Helen, who has inherited some funds and has just started her first job after University.

Interest based products

Interest based products are frequently a component part of an individual's investment portfolio. They include bank and building society accounts, government stock, company debentures, loans and bonds and National Savings and Investment bank (NS & I) products such as savings certificates.

Tax characteristics

Interest is generally taxable although there are some tax free interest products. These include interest on an Individual Savings Account (ISA), various products from NS & I and certain provisions for children.

Some taxable interest is paid to the individual in full without deducting tax at source. Key examples include interest on most government loan stock and certain NS & I products. This is useful where the recipient is not a taxpayer as it avoids the need to claim a tax refund, but for taxpayers it means they will have to account for the right tax to HMRC.

Most taxable interest received by an individual has 20% tax deducted already, so a basic rate taxpayer has no further tax to pay. For a higher rate taxpayer there is an additional 20% still to pay.

However, for some individuals such as children, students, non working adults and pensioners a tax refund may be due which has to be claimed from HMRC.

Comment

Some taxpayers may not be liable for any tax or liable for only 10% tax on interest received. Where tax of 20% has been deducted already, a repayment claim will be necessary to recover the tax. Where no tax liability is anticipated for the tax year you can instruct the bank/building society not to deduct tax at source by completion of a form R85.

Equity based products

Investing in company shares can be used for both income return and capital growth depending on how the investment is structured. The available choices are significant, ranging from direct investment in the shares of a single unquoted trading company, to owning units in a fund which has a worldwide portfolio of shares in listed companies.

Income tax treatment

The income from shares referred to as a dividend is generally taxable. It is either chargeable on an individual @ 10% or 32.5%. For basic rate taxpayers there is no actual tax to account for because all recipients are given a tax credit, which is used solely for the purpose of cancelling out the 10% tax charge. No refunds are possible for non taxpayers. For higher rate taxpayers they have to settle the additional tax.

Capital gains tax (CGT) treatment

Any increase in the value of shares or share based products is generally chargeable to CGT on disposal. In certain situations a relief may be available to reduce or even defer a gain. Individuals also have an annual CGT exemption which currently stands at £10,100 to exempt their gains with any excess then chargeable @ 18%.

Comment

CGT reliefs are mainly available on business shares - an example is Entrepreneurs' Relief which requires that an individual has both a minimum 5% shareholding and is either an employee or officer of the relevant trading company in the 12 months up to a disposal. So, where the individual is not involved in the company, other than as a shareholder, this particular relief would not be available to reduce the chargeable gain.

Where losses on equity investments arise, these can only generally be relieved against other gains. However, there may be scope to relieve a capital loss against total income where the loss has arisen from an original investment in new unquoted trading company shares.

Buy to let property investments

The UK property market, whilst cyclical, has proved over the long-term to be a very successful investment. This resulted in a massive expansion in the buy to let sector in recent years.

For many investors buy to let involves acquiring property with the expectation of capital growth with the rental income from tenants covering the mortgage costs and any outgoings.

However, the gross return from buy to let properties - meaning the rent received less costs such as letting fees, maintenance, service charges and insurance - is no longer as attractive as it once was. Investors also need to take a view on the likelihood of capital appreciation exceeding inflation. Investors should take a long-term view and choose properties with care.

Which property?

Investing in a buy to let property is not the same as buying your own home. You may wish to get an agent to advise you of the local market for

rented property. An agent will also be able to advise you of the standard of decoration and furnishings which are expected to enable a quick let.

Letting property can be very time consuming and inconvenient. Tenants will expect a quick solution if the central heating breaks down over the bank holiday weekend! Do not cut corners - a correctly drawn up tenancy agreement will ensure the legal position is clear.

Tax position

Income tax (IT) is generally payable on the rent receivable after deducting allowable expenses. Allowable expenses include mortgage interest, repairs, agent's letting fees and an allowance for any furnishings provided.

The eventual disposal of a buy to let property is chargeable to CGT on the difference between the proceeds and any capital costs incurred. As with share disposals, where a gain arises any excess is charged at 18% after the annual exemption is used.

Tax efficient savings options

Individual Savings Accounts (ISAs)

ISAs are free of IT and CGT. There are maximum investment limits which apply for each tax year but no lifetime limits so over several years, large investments can be built up.

The ISA can be in stocks and shares or cash.

Individual Savings Accounts		
		2009/10
Overall investment limit		£7,200
comprising	- cash up to	£3,600 max.
	- balance in stocks and shares	Overall £7,200 max.

Increase in limits

- From 6 October 2009 the ISA limits for people aged 50 and over will be raised to £10,200, of which £5,100 can be held in cash.
- The current ISA limits will be increased for all investors to the same amount from 6 April 2010.

Single Premium Investment bonds

This type of investment involves placing a lump sum into an insurance company fund which is invested over a number of years. It allows for the provision of tax efficient income for the duration of the plan. Withdrawals from the bond are tax free for basic rate payers and higher rate taxpayers can defer the charge to higher rate tax or even avoid it in certain circumstances. There is also normally no CGT liability on the maturity of the policy.

The Enterprise Investment Scheme (EIS)

EIS was introduced to encourage direct investment in unquoted trading companies.

Each investment is generally a speculative equity investment in a single company over at least a three year period. Such investments are generally considered to be higher risk and so there are a number of attractive tax incentives available for the individual.

- Income tax relief at 20% is available on new equity investment (in qualifying unquoted trading companies) of up to £500,000 in 2009/10. The relief can be used against the current period's tax liability or carried back for relief.
- Gains on share disposals will be exempt if EIS shares are held for at least three years.
- Losses on EIS share disposals are generally allowable against income or gains.
- Where disposals of other types of chargeable assets (eg quoted shares, second homes, etc) are made, the gain can be deferred, where proceeds are reinvested in EIS shares.

Comment

This scheme is most suitable for those individuals who have a significant sum to invest. It can also accommodate those who may seek to offer commercial expertise to a qualifying unquoted trading company. Investment aims are capital growth over a medium to long-term period.

It is also clearly of interest for trading companies seeking external finance for development, but detailed rules must be observed so please contact us if this is of interest to you.

Venture Capital Trusts (VCTs)

VCTs were introduced on the back of EIS to encourage indirect investment in unquoted trading companies. A VCT is essentially a quoted company which is required to invest at least 70% in a portfolio of qualifying unquoted trading companies.

An individual investor in the shares of a VCT will be exempt from tax on dividends and on any capital gain arising from disposal of the shares in the VCT. Income tax relief currently at 30% is available on subscriptions for VCT shares, up to £200,000 per tax year, so long as the shares are held for at least five years.

Collective investments

VCTs are one type of what is commonly referred to as 'collective investments'. The other examples do not have any special tax reliefs but have a much greater flexibility to spread their risk by investing in a variety of cash, asset and equity based funds both in the UK and internationally. Examples of collective investments include unit trusts, open ended investment companies, investment trusts and insurance company funds. Returns can either be geared for income producing or capital growth but are generally taxable under both IT and CGT in the normal way.

What about savings for children?

There are a number of savings products which are totally tax free and available only for children.

Child Trust Fund (CTF)

Generally any child born on or after 1 September 2002 is entitled to either a £250 or £500 voucher, depending on the level of family income, to set up a CTF. A further £250 or £500 is due when the child reaches the age of seven. A CTF is a long-term savings and investment account as the money cannot be withdrawn until the child is 18 but anybody can add funds to it up to a maximum of £1,200 overall a year. There is no tax on any interest or gains.

Children's Bonus Bonds (NS & I)

NS & I Children's Bonus Bonds provide tax-free interest for children under 16, with an additional bonus if the money remains untouched for five years.

ISA accounts

Children aged 16 and over can invest in a cash only ISA, which earns interest tax free. Otherwise children are treated the same way for tax as adults and so have a personal allowance available to offset taxable investment income.

However, if as a parent or step-parent you give any investment funds to your child that earn more than £100 interest a year, it is taxed on you not the child. This rule does not apply to gifts from grandparents and other adults.

Inheritance Tax (IHT) and Investments

At death

There are no exempt assets for IHT so on death all investments are included in the chargeable estate. This includes investments which during lifetime may have qualified for tax free IT and/or CGT status, for example ISA accounts.

The only exemptions which generally apply at death are gifts to a spouse or charity. Certain equity investments, such as unquoted trading company shares, may qualify for Business Property Relief which can reduce the amount chargeable by up to 100% depending on certain qualifying conditions.

Lifetime gifts

During lifetime there is a wider range of actual and conditional exemptions available under IHT. This allows more flexibility to transfer funds to other family members so that they can make their own investments or for you to gift existing investments.

Further Advice

If you would like more information on any matter contained in this briefing then please contact us for assistance. Specific individual advice on many of the investments included in this briefing is regulated by the Financial Services and Markets Act (FSMA) 2000.