His and hers

Because a married couple or registered civil partners have separate tax allowances and lower rate bands, there are significant savings if income and gains can be split between them rather than all being earned by one. This usually involves an outright gift of the underlying asset to the other half – and that gift does not trigger any tax charges.

Example

Ben and Jill are married. Ben has no income, while Jill has a salary of £150,000 a year. This means that any investment income she has is taxed at 50% (savings) or 42.5% (dividends). She will also pay CGT at 28% on any gains above £10,100.

If Ben holds the investments, he can use his personal allowance and basic rate band for income tax, and may pay CGT at only 18%.

The expert investor

This guide has only considered the general principles which apply to common types of investment. There is, of course, a bewildering variety of products on offer to people who are willing to take a chance. The tax treatment can make some of these better or worse, but it will always be important to understand what the tax treatment is before you put your money down. Venture Capital Trusts, Enterprise Investment Schemes, offshore funds, zero-coupon prefs – they all have their own tax rules which investors should understand.

How we can help

An investment decision should always be taken on the basis of proper investment advice. An important part of understanding that advice is appreciating the tax consequences of the investment decision, both at the time and in the future – income or gains? Tax relief? What choices may affect the timing and amount of any tax charges? Any investment involves an element of risk, but we can help make sure you know what the tax consequences will be.

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The information contained in this report is intended for guidance only. We recommend that you seek specific, detailed advice before acting on any of the matters contained herein.

Tax and Savings

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Tax and Savings

Any investment involves an element of risk, but we can help make sure you know what the tax consequences will be.

Promises, promises

Many investments are advertised as giving you a tax break. But what's it really worth? Some providers of tax-free ISAs have been criticised for paying pitiful rates of interest – on 0.1% a year you don't have much income whether or not the taxman gets a cut. So what difference do the tax rules make to where you ought to put your money?

Wag the dog

This brief guide won't describe any specific investments, but there is one fundamental principle that applies to all of them: a tax break can't make a loser into a winner. Don't let the tax tail wag the investment dog. If something doesn't pay a decent return, of course there won't be any tax – it could be tax efficient, but you're still losing money.

Tax-free

There are some investments that are advertised as "tax-free". Many National Savings products pay interest which is not taxable – but the returns are fixed and limited.

Individual Savings Accounts (ISAs) allow a saver to invest up to £5,100pa in cash, or up to £10,200 in stocks and shares, and pay no tax on income or gains. That's a good thing, but it mainly helps the better off – people who already use up their CGT annual exemption and who would pay higher rate income tax on dividends. If the charges are the same, you might as well put your money into an ISA as any other form of investment – but if you are a basic rate taxpayer, it's hardly worth paying for the privilege. And watch the rates on cash ISAs – some of them pay so little that you'd be better off with 60% of the return on a higher interest account that's taxable.

Income or gains

At the moment, the main rates of income tax go up to 50% – or 42.5% on dividend income, less a 10% tax credit. Capital gains are charged at 18% or 28%, depending on whether you are a basic or higher rate income tax payer, and there is a generous tax-free amount each year of £10,100. As a general rule, then, if you can earn your return as a capital gain you keep more of it.

Example

Kim and Chris both have salaries which use up all but £5,000 of their basic rate tax band. Each invests a £100,000 windfall in a product that produces a return of £15,000 over a year – the only difference is that Kim gets interest income while Chris makes a gain.

Kim will pay tax at 20% on £5,000 and 40% on £10,000, and will keep £10,000. Chris will pay tax at 18% of only £4,900, and will keep £14,118.

If you make a capital loss, you can set it against other capital gains before working out your tax. But you can't usually reduce your income tax with capital losses.

Changing the tax

So, what produces gains? There are plenty of investments that only produce income – deposit accounts are safe but boring. Open ended investment companies (OEICs), unit trusts and shares in companies generally produce income and gains, but the value can go down as well as up.

It's also possible to invest in OEICs through a single premium life insurance policy. This is an insurance "wrapper" around something that is always intended to be an investment – the holder probably intends to cash it in rather than die and leave the proceeds to someone else. An insurance bond changes the tax treatment completely: the income from the investment is not taxed as it arises (good if you are a higher rate taxpayer) and a capital gain on encashment is charged to higher rates of income tax rather than to CGT. Conversely, losses are not generally relieved at all.

What a relief

Some investments are positively encouraged by the tax system – you reduce your tax bill if you make them, so the taxman is effectively contributing to the cost. The most important is contributions to a registered pension scheme, where most people enjoy relief at their marginal tax rates for contributions made. You pay 80% of the premium to the pension company, and if you are a 40% taxpayer you can knock another 20% off your tax bill – so £100 in the scheme only costs you £60. Once it's in, the money earns interest and gains with no further tax at all until you come to draw a pension.

The main problem with pension savings is that you are not allowed to draw the whole pot as a lump sum – you can have a quarter on retirement, but the rest has to provide you with an income. Still, the tax break is so significant that Alistair Darling took steps to restrict it for the highest earners – anyone earning over £130,000 should now take advice before paying contributions over £20,000 a year.