Savings and investments

Before you invest your nest egg for that rainy day, make sure you know what will happen to the money you make from it

The income you make from your savings and investments is treated in one of three ways for tax purposes: tax-free (you do not have to declare it); taxable but paid net (that is, with tax already deducted – referred to as 'taxed' in this chapter); and taxable and paid gross (that is, not taxed before you get it, so you have to declare the income and, unless you are a non-taxpayer, pay tax on it – referred to as 'taxable' here). The table on p37 shows how a range of investments is taxed for people who live in the UK.

THE RATE YOU PAY

The rate of tax you pay on your investment income depends on your overall income and on whether it comes from savings or dividends. To find out what rate you'll pay, you need to know your taxable income.

Add together:

- your savings and investment income
- any other income (including from your work).

Then subtract:

- your personal allowance
- any other tax reliefs.

If the total is within the starting-rate tax band (up to £2,150), you pay 10 per cent on both your savings and dividend income. Any savings income that falls in the basic-rate band (£2,151 to £33,300) attracts tax of 20 per cent; any dividend income that falls in the basic-rate band is taxed at 10 per cent. Any savings income that falls in the higher-rate band (over £33,300) is taxed at 40 per cent; any dividend income that falls in the higher-rate band attracts tax at 32.5 per cent. (For tax purposes, dividend income is the dividend plus the tax credit.)

When allocating your allowances and tax bands, dividends are treated as your top slice of income (after capital gains), savings are treated as your next slice, and other income is treated as your first slice – for an example of how this works plus the tax bands for 2005-2006, see p6.

ACTION POINTS

Make the most of tax-free investments
You get tax breaks by putting your money into Isas and some National Savings & Investments products.

Claim back the tax
Non- and starting-rate taxpayers can claim back any tax deducted from interest payments on savings accounts.

Check tax rates
Savings and investments are taxed at different rates. Ensure you're paying the right amount.

Declare your savings income
Higher-rate taxpayers have further tax to pay so may need to fill in a tax return.

THE RATE YOU PAY AT A GLANCE

If your taxable income for 2006-2007 is...	on savings income you pay...	on dividend income you pay...
up to £2,150	10% tax on any income that falls in this band	10% tax on any income that falls in this band
£2,151 to £33,300	20% tax on any income that falls in this band	10% tax on any income that falls in this band
over £33,300	40% tax on any income that falls in this band	32.5% tax on any income that falls in this band

ALAMY

HOW INVESTMENTS ARE TAXED

A guide to what investments are tax-free, taxed already and taxable

Your choice of savings and investment products should be determined, in part at least, by how any income and gains are taxed.

TAX-FREE INVESTMENTS

You do not have to declare tax-free investments and you have no tax to pay on them.

Isas

Income and gains from Isas (individual savings accounts) are free of income and capital gains tax. (However, dividends on stocks and shares Isas are paid with 10 per cent tax deducted.) Isas are available only to UK residents. Anyone aged 16 or over can take out a cash Isa but you have to be at least 18 to take out a stocks and shares Isa. Until April 2010, you can pay in up to £7,000 in any one tax year. You can invest up to £3,000 in a mini cash Isa and up to £4,000 in a mini stocks and shares Isa. Alternatively, you can invest the whole £7,000 into a maxi stocks and shares Isa with one provider. Whichever type you have, the limits apply to what you pay in, not your balance.

For more on mini cash Isas, see 'Bag a nicer Isa', *Which?*, March 2006, p28.

NS&I

National Savings & Investments offers several tax-free products, including its own cash Isa, savings certificates (both fixed-interest and index-linked), and children's bonus bonds. Winnings on premium bonds are also tax-free.

Child trust funds

Children born from 1 September 2002 receive at least £250 when a parent starts receiving child benefit and a further payment when they reach seven, to be invested in cash or stocks and shares. A total of £1,200 a year can also be added to the fund on your child's behalf. The trust isn't accessible until your child's eighteenth birthday and the money belongs to them. See 'Tax and your family', p39.

BUYING OR SELLING GILTS

If you buy or sell gilts, you may come within the accrued income scheme. In this case, part of the price you get when you sell may be taxable. See page 12 of HMRC's tax return guide, and for more details on the accrued income scheme visit HMRC's website (see 'More help', p38).

The accrued income scheme does not apply if the nominal or face value of all accrued income scheme securities you hold is less than £5,000 at all times in the tax year in which you buy or sell them and throughout the previous tax year.

TAXED INVESTMENTS

Most UK savings accounts and investments in stocks and shares are taxable, and interest and dividends are paid net (with tax already deducted). Non-taxpayers can get interest on savings accounts paid gross or reclaim overpaid tax but can't reclaim tax paid on dividends.

Savings income

Savings income includes interest from bank or building society accounts, certain NS&I accounts, gilts, corporate bonds, permanent interest-bearing shares (PIBS), local authority investments, and income from authorised unit trusts or open-ended investment companies (Oeics) that invest mainly in these types of interest-bearing investments. Income from annuities you buy voluntarily, as opposed to those you have to buy with pension fund proceeds, also comes into this category.

Interest on most savings is paid after tax of 20 per cent (the savings rate) has been deducted by the provider. The provider then pays the tax to Revenue & Customs. Basic-rate taxpayers have no more tax to pay; higher-rate taxpayers have to pay a further 20 per cent tax, usually through their tax return. If you don't receive one, it is your responsibility to tell your tax office if you have extra tax to pay.

Because they are liable to pay tax at only 10 per cent, starting-rate taxpayers can claim back half the tax the provider has deducted. Non-taxpayers can claim it all back by completing form R40, available from your tax office. You don't need to wait until the end of the tax year to claim, though refunds of less than £50 are not normally repaid mid-year. Alternatively, non-taxpayers can register to have bank and building society interest paid gross – get form R85, and its accompanying helpsheet, from your bank or building society or any tax office or tax enquiry centre.

Dividend income

Dividend income comes from UK shares and dividend distributions from share-based Oeics and unit trusts. UK dividends are paid with a 10 per cent tax credit, regardless of whether you choose to reinvest your income or have the dividend paid in cash (or shares). This means, in effect, that 10 per cent tax has already been deducted.

This tax credit meets the tax liability for starting- and basic-rate taxpayers on this type of income, so they pay no more income tax. Non-taxpayers also have this tax deducted but they can't claim it back. Your dividend or distribution voucher should show the tax credit. Higher-rate taxpayers pay a further 22.5 per cent (of the gross dividend), usually through their tax return.

If you have shares in foreign-based companies, your dividend may be taxed abroad without a UK tax credit and, depending on the country, you may be eligible for some UK tax relief.

TIP

You can no longer open a Tessa or a Pep. The last Tessas matured on 5 April 2004. If you transferred the capital to a Tessa only Isa (Toisa), you can transfer the Toisa between providers or to a cash Isa without it affecting your annual Isa allowance. You cannot transfer your Pep to an Isa.

TAXABLE INVESTMENTS

Income on the following types of investments is paid gross (that is, without tax deducted). Unless you're a non-taxpayer, you have to declare it and pay tax.

NS&I

Interest on capital bonds, income bonds, guaranteed equity bonds, investment accounts, pensioners' bonds and the Easy Access Savings Account (EASA) is all paid gross.

British Government stocks

The interest on gilts (gilt-edged securities) that you acquired since 6 April 1998 is usually paid gross, but you can ask to have it paid net of tax. Conversely, gilts that you bought before 6 April 1998 pay interest net, although you can choose to be paid gross.

Corporate bonds and PIBS

If you invest directly in corporate bonds and permanent interest-bearing shares (PIBS), most will pay the interest gross, so you will have to declare it on your tax return if there is tax to pay. If you invest through a unit trust or Oeic, however, distributions are paid with tax at the savings rate already deducted.

Offshore accounts

Interest on offshore accounts and investment funds, such as those based in the Channel Islands or Dublin, is paid gross, though this doesn't mean it is tax-free. UK residents are normally charged on the full amount of foreign income arising abroad, whether it is brought into the UK or not. You need to declare this type of income on your tax return using the supplementary pages for foreign income. However, some offshore jurisdictions apply a withholding tax on your savings – if this applies to you, you should declare this as well, as you can claim a UK tax credit for it.

There are different rules for people who are not domiciled in the UK – see HMRC leaflet IR20 *Residents and non-residents: liability to tax in the UK.*

HOW INVESTMENTS ARE TAXED AT A GLANCE

Our table shows how some investments are taxed for UK residents. Taxable means you have tax to pay (unless you are a non-taxpayer); taxed means tax has already been deducted

Type of income	Status			Notes
	Taxable	Taxed	Tax-free	
Accounts (held in £ or foreign currency) at a UK branch of a bank or building society		✓		Non-taxpayers can receive this gross
Accounts at an offshore (eg Jersey, Isle of Man) branch of a UK or foreign bank or BS	✓			May be subject to a 'witholding' tax
Annuities		✓		Non-taxpayers can receive this gross
British government stocks (gilts) acquired since 6 April 1998	✓			No capital gains tax to pay; taxpayers can apply for net payment
British government stocks (other)		✓		No capital gains tax to pay; taxpayers must apply to receive gross
Child trust funds			✓	But dividends taxed at 10%, which can't be reclaimed
Co-operative Society deposits	✓			
Corporate bonds, debentures, loan stock and other fixed-income investments	✓			No capital gains tax if they count as qualifying corporate bonds
Credit union deposits	✓			
Friendly society tax-exempt plans			✓	But dividends taxed at 10%, which can't be reclaimed
Interest from private individuals	✓			
Interest on distributions under a will		✓		
Isas			✓	But dividends taxed at 10%, which can't be reclaimed
Loans to foreign governments		✓		In foreign currency, may be received gross but taxable
Local authority loans		✓		Non-taxpayers can receive this gross
NS&I: Easy Access Savings Account (EASA)	✓			
National Savings certificates			✓	
National Savings children's bonus bonds			✓	
National Savings fixed rate savings bonds		✓		
National Savings: other accounts and bonds	✓			
Offshore managed funds	✓			
Open-ended investment company distributions (Oeics)		✓		Profits on sale taxed as capital gains
Permanent interest-bearing shares (PIBS)	✓			No capital gains tax if count as qualifying corporate bonds
Personal equity plans (Peps)			✓	But dividends taxed at 10%, which cannot be reclaimed
Premium Bond prizes			✓	
Proceeds from non-qualifying UK life insurance policies	✓			Only if you pay higher-rate tax; if not, treated as a qualifying policy (below)
Proceeds from qualifying UK life insurance life insurance policies (usually)			✓	But insurance company has paid tax which can't be reclaimed
Proceeds from non-UK life insurance policies	✓			
Save-as-you-earn accounts			✓	
Share dividends from UK companies		✓		Profits on sale taxed as capital gains
Tax rebate interest			✓	
Traded options		✓		Taxed as capital gains unless linked to gilts or qualifying corporate bonds
Trusts and settlements: income payments to beneficiaries		✓		
Unit trust distributions		✓		Profits on sale taxed as capital gains
War loans	✓			No capital gains tax to pay

LIFE INSURANCE

How income from insurance policies, including friendly society policies, is taxed

The way life insurance policies are taxed depends on whether or not they are UK-based and whether they count as qualifying or non-qualifying.

UK LIFE INSURANCE

You can invest in an investment-based life insurance policy either by paying regular monthly or annual premiums (an endowment policy, say) or by investing a lump sum (known as single-premium bonds or investment bonds).

The insurance provider pays tax on the income and capital gains from the underlying fund into which your investment goes. All taxpayers, as well as non-taxpayers, therefore indirectly pay some tax. You can't claim this tax back.

As a result, life insurance investment policies are not tax-free investments. However, the fact that insurance providers pay tax on the underlying investments means that everyone's liability to savings-rate tax on any life insurance investment is covered.

If you're a higher-rate taxpayer, however, and your policy is what is classed as non-qualifying (see 'Qualifying and non-qualifying policies', right), you'll pay an extra 20 per cent tax (the difference between higher-rate and savings-rate tax) on the gain from the policy when you cash it in or it matures. The gain is calculated by adding up how much you receive from the final payout and subtracting what you paid in overall.

In addition, if you withdraw more than 5 per cent of the policy's capital in any year before the policy matures, the withdrawal will be treated as a gain in that tax year and you will be taxed accordingly.

However, you are allowed to withdraw less than 5 per cent of the capital without paying tax immediately. And this 5 per cent allowance can be rolled up for anything up to 20 years – so if you don't withdraw any capital for the first two years, say, you could withdraw 15 per cent in year three and so on. When the policy does mature, these earlier 'tax-free' withdrawals are added to the final gain (so you will eventually pay tax).

If the policy is qualifying, you don't pay tax on the gain when it matures, whatever your rate of tax.

NON-UK LIFE POLICIES

Life policies from insurers based outside the UK are taxed differently. Gains from such policies are taxed at the normal tax rate since the insurers do not pay UK tax on the underlying investments. So a basic-rate taxpayer will pay tax on gains at 20 per cent; a higher-rate taxpayer, 40 per cent tax. As with UK policies, you can withdraw up to 5 per cent of the capital in any year without it counting as a gain.

QUALIFYING AND NON-QUALIFYING POLICIES

The majority of regular-premium investment policies, such as most endowments, are usually classed as qualifying policies, so you pay no tax on the proceeds when the policy matures. But a qualifying policy becomes a non-qualifying policy if you cash it in or stop the premiums before it is three quarters of the way through or within the first ten years (whichever is shorter). Lump-sum policies and regular-premium policies of less than ten years are also non-qualifying policies. If in doubt, ask your provider what the status of the policy is.

TIP

Friendly societies offer investments through tax-free insurance plans that must last at least ten years. Unlike other insurance policies, tax-free friendly society policies pay only 10 per cent tax on the underlying investment, but charges can be high, especially in the early years. You can invest up to £270 a year if paid in a lump sum or £300 a year monthly. Be aware that friendly societies also sell standard insurance policies that are not tax-free.

DIVIDENDS FROM UNIT TRUSTS AND OEICS

If you receive dividends from unit trusts or open-ended investment company distributions (Oeics), you may have accumulation units. With accumulation units, the dividend or interest is reinvested in the unit trust or Oeic. This counts as income for tax purposes for the year in which the income is reinvested. You must enter it into your tax return as either interest payments or dividends (depending on the type of fund it is invested in). For more advice, speak to your unit trust or Oeic manager.

NS&I Capital Bonds are treated in the same way – so although you get the payout only after five years, you have to pay tax on the income credited to the bond each tax year.

MORE HELP

HMRC leaflets

- IR284 Shares and capital gains tax
- IR 320 Gains on UK life insurance policies
- IR 321 Gains on foreign life insurance policies

Websites

For Best Buy savings accounts and cash Isas
www.which.co.uk/whichextra
For general information
www.hmrc.gov.uk
For accrued income schemes
www.hmrc.gov.uk/guidance/ais.htm
For information on Isas
www.hmrc.gov.uk/leaflets/isa.htm
For NS&I products
www.nsandi.com
For tables to compare products
www.fsa.gov.uk/tables
For a basic introduction to tax on savings
www.direct.gov.uk