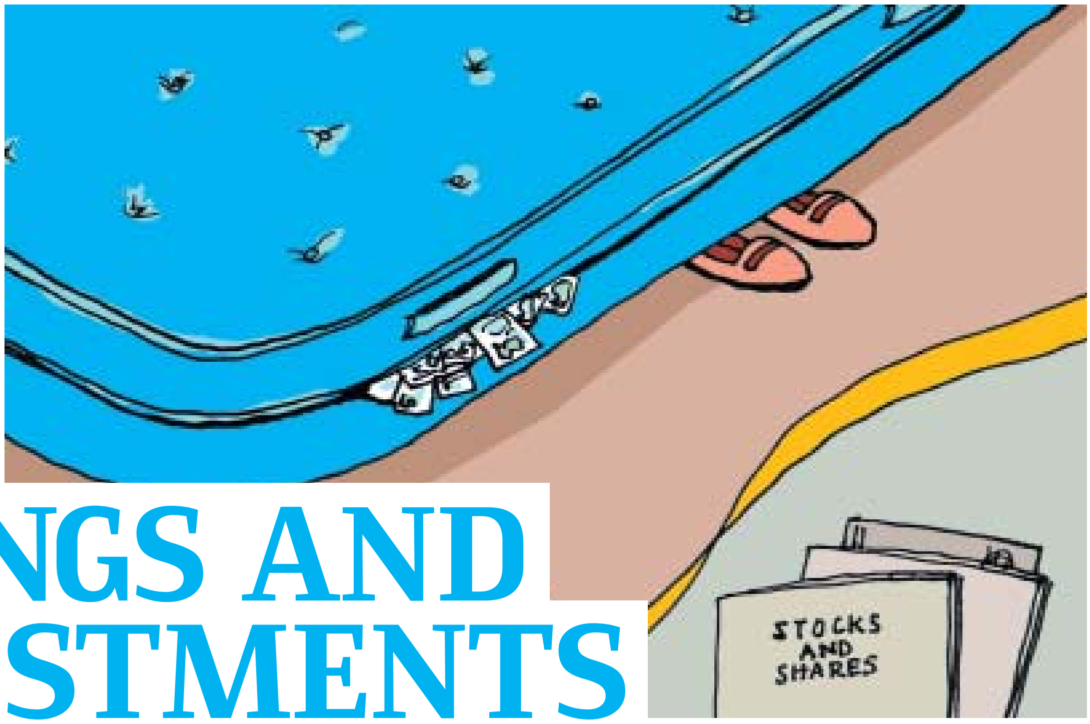


SAVINGS AND INVESTMENTS

Your choice of savings and investments should be determined, in part at least, by your tax status and how any income and gains are taxed

The income that you get from savings and investments is treated in one of three ways for tax: taxed before you get it (paid net), taxable but paid gross, or tax-free. The table on p50 shows how a range of investments are taxed. See p51 for how life insurance investments are taxed.

WHAT RATE DO YOU PAY?

To find out what rate you will pay, first add your savings and investment income to any other income you have. Then deduct your personal allowance and other tax reliefs. If your remaining income (known as your taxable income) when added together is below the level of the starting-rate tax band (£2,090 for 2005-2006), you pay 10 per cent tax. If it falls into the basic-rate tax band (£2,090 to £32,400), you pay 20 per cent tax on any savings income in that band. Any taxable savings income in the higher-rate tax band (over £32,400) attracts tax at 40 per cent.

Dividend income (for tax purposes this is the dividend plus the tax credit) up to the limit of the basic-rate band (£32,400) is taxed at 10 per cent. Above this, it's taxed at 32.5 per cent. For the purposes of allocating your allowances and tax bands, dividends are treated as your top slice of income, savings are treated as your next slice, and other income is treated as your first slice.

TAXABLE AND PAID NET

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

Savings income

Savings income includes interest from bank or building society accounts, certain National Savings & Investments accounts, gilts, corporate bonds, permanent income-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 that you buy voluntarily, as opposed to those you have to buy with pension fund proceeds, also comes into this category.

Interest on most savings income is paid after tax of 20 per cent (the 'savings rate') has been deducted by the provider. The provider then pays the tax to the Inland Revenue. 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 a tax return, it's your responsibility to notify your tax office if you have extra tax to pay on savings income.

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 the tax office. You don't need to wait until the end of the tax year to make a claim, although if the refund is less than £50, it is not normally repaid mid-year. Alternatively, non-taxpayers can register to have bank and building society interest paid gross – you will need form R85 and its accompanying helpsheet, available from your bank or building society or any Inland Revenue area office or enquiry centre.

If you have a joint account and one of you is a non-taxpayer, you may be able to register to have half the interest paid gross and half paid net. However, not all providers allow you to do this. If you are with a provider which doesn't, you will have to claim back any tax you've overpaid. Non-taxpayers can also register to have income

ACCUMULATED INTEREST

If you receive dividends from unit trusts or Oeics, you may have accumulation units. With accumulation units or shares, the dividend or interest is reinvested in the unit trust or Oeic for you. This counts as income for tax purposes for the year in which the income is reinvested and must be entered 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 nevertheless have to pay tax on the income credited to the bond each tax year.

from voluntary annuities paid without tax deducted – you will need form R89, from the Revenue or your annuity provider.

Dividend income

Dividend income comes from UK shares and dividend distributions from share-based Oeics and unit trusts. Dividends are paid with a tax credit of 10 per cent, irrespective of whether you choose to reinvest your income or have the dividend paid in cash (or shares). This means, in effect, that you are receiving a net amount. The tax credit meets the tax liability for starting- and basic-rate taxpayers on this type of income, so they have no more income tax to pay. Non-taxpayers also have this tax deducted, but, unlike with savings income, they can't claim it back. The tax credit should be shown on your dividend or distribution voucher. Higher-rate taxpayers pay a further 22.5 per cent (of the gross dividend), usually through their tax return.

TAXABLE AND PAID GROSS

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

National Savings & Investments

Interest on Capital Bonds, Income Bonds, Guaranteed Equity Bonds, Investment Accounts, Pensioners' Bonds and the Easy Access Savings Account (EASA) is all paid gross. The same is true for interest on the Ordinary Account, though the first £70 (£140 if the account is joint) is tax-free. The Ordinary Account is now closed to new investors and also to further deposits from existing investors.

Gilts

The interest on gilts (gilt-edged securities) that you have 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.

If you buy or sell gilts, you may come within the accrued income scheme – see Revenue leaflet IR68. In this case, part of the price you get when you sell may be taxable as the equivalent of interest. See page 11 of the Inland Revenue guide for what to put where in your tax return.

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 any time in the tax year in which you buy or sell them and throughout the previous tax year.

Corporate bonds and PIBS

If you invest directly in corporate bonds and permanent interest-bearing shares (PIBS), most will pay the interest gross, and you will therefore 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. Declare this type of income on your tax return using the supplementary pages for foreign income. There are different rules for people who are not domiciled in the UK – see Revenue leaflet IR20 for more information.

TAX-FREE INVESTMENTS

The main tax-free investments currently available are Isas (individual savings accounts) and some products from National Savings & Investments.

Isas

Isas are available only to UK residents. Anyone aged 16 or over can take out a cash Isa but you have to be 18 or over to take out a stocks and shares Isa. Currently, you can pay up to £7,000 into Isas – this limit has been set until this tax year ends on 5 April 2006.

Anyone who is aged 16 or over can take out a cash Isa

You can hold a cash Isa (through, for example, a savings account with a building society or bank) or a stocks and shares Isa (through investments such as shares, unit trusts, and so on). From 6 April this year, however, the life insurance component of Isas merges into the stocks and shares component (see below), meaning you can no longer open a separate life insurance Isa.

In the 2005-2006 tax year, you can invest your whole £7,000 allowance into a maxi Isa with one provider, or open up to two mini Isas with two different providers (the merging of the life insurance element into the stocks and shares element this year means there are now just two types of mini Isa).

A maxi Isa must have a stocks and shares element, but it can also include a cash element offered by the same provider. In practice, though, most simply give the option to invest in stocks and shares. Currently, you can invest any amount up to £7,000 each tax year in stocks and shares or life insurance via a maxi Isa. If you choose a maxi that offers both cash and stocks and shares, you can put any amount up to £3,000 in the cash part and the remainder in the stocks and shares

TAX RETURN

You will need to include details of any taxable interest, dividends, income distributions or other taxable investment income. Enter all savings and investment income from UK investments in the basic tax return – overseas income goes in the supplementary foreign pages (F1 to F5).

- Separate interest where no tax has been deducted from interest paid with tax deducted.
- The voucher that accompanies your dividend payment shows the amount you have been paid and the tax credit. Total all income received from dividends and add to the amount of tax credits (shown on the voucher) to give the total dividends or distributions plus tax credits. Interest distributions, from gilt or bond unit trusts, say, go in the interest section. If you don't receive a dividend tax voucher, ask for one. You can now have them issued electronically. Special rules apply for reinvested income (see 'Accumulated interest', opposite).
- Scrip (or stock) dividends count as taxable income only if the shareholder has an option to take cash, in which case you should enter them on the tax return. A bonus issue of shares is not taxed as income, but a subsequent sale could incur capital gains tax – see p52.
- Include details of non-qualifying distributions (such as a bonus issue by a company of securities or redeemable shares to an employee, or the paying on of a bonus received by the company) and loans written off.

HOW INCOME IS TAXED FOR UK RESIDENTS

Type of income	Taxable	Taxed	Tax-free	Notes
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	✓			
Annuities		✓		Non-taxpayers can receive this gross
British government stocks (gilts) acquired since 6 April 1998	✓			No CGT to pay; taxpayers can apply for net payment
British government stocks (other)		✓		No CGT to pay; taxpayers must apply to receive gross
Co-operative Society deposits	✓			
Corporate bonds, debentures, loan stock and other fixed-income investments	✓			No CGT if they count as qualifying corporate bonds
Credit union deposits	✓			
Friendly society tax-exempt plans			✓	Dividends taxed at 10%, which can't be reclaimed
Interest from private individuals	✓			
Interest on distributions under a will		✓		
Isas			✓	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)	✓			
NS&I: Ordinary Account:				Closed to new investors;
■ first £70 (£140 joint account)			✓	no further desposits from
■ remainder	✓			existing investors allowed
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 CGT if count as qualifying corporate bonds
Personal equity plans (Peps)			✓	Dividends taxed at 10%, which cannot be reclaimed
Premium Bond prizes			✓	
Proceeds from qualifying life insurance policies (usually)			✓	But insurance company has paid tax which can't be reclaimed. For non-qualifying policies, higher-rate taxpayers pay extra tax
Save-as-you-earn accounts			✓	
Share dividends from UK companies		✓		Profits on sale taxed as capital gains
Tax exempt special savings accounts (Tessas)			✓	Must be kept for 5 years
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 CGT to pay

element (which includes life insurance). Alternatively, you can invest in mini Isas with different providers. The annual limits are, currently, £3,000 into a mini cash Isa and £4,000 into a mini stocks and shares Isa.

Isa limits are under review. They were due to be reduced from April 2006, with the maxi limit falling to £5,000 and the mini cash Isa limit to £1,000. (The mini stocks and shares Isa limit was to stay at £4,000.) However, the Chancellor announced plans in his 2004 pre-budget report to extend the 2005 limits to 2009, subject to consultation.

You can't invest in a maxi and mini Isa in the same tax year, and you can't open two mini Isas of the same type (two mini cash Isas, say) in any one tax year.

Whichever type of Isa you have, the limits apply to what you pay in, not your balance. So, if you put £3,000 in a mini cash Isa, you will have used up your allowance. If you then withdraw £100, you won't be able to pay it back in later during the same tax year.

Income and gains from Isas are free of income and capital gains tax. Since 6 April 2004, stocks and shares Isa managers have not been able to reclaim the 10 per cent tax on UK dividends received into the fund. This change has reduced the tax advantages of some stocks and shares Isas, because, although holders still have no personal liability for income tax or capital gains tax, it could have reduced the return on investments.

Tessas

The last Tessas matured on 5 April 2004, so you can no longer open a new one or add to an existing one. If you transferred your Tessa capital to a Tessa Only Isa (Toisa), you can transfer the Toisa between providers and, after its first year, you can transfer the Toisa to a cash Isa without affecting your annual Isa allowance.

Peps

You can no longer open a new Pep or add to an existing one. You can transfer an existing Pep from one manager to another but you cannot transfer existing Peps to an Isa.

National Savings & Investments

National Savings & Investments (NS&I) 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, as is the first £70 of interest earned in each tax year on NS&I's Ordinary Instant Access Account. However, it is no longer possible to open an Ordinary Account, or to make deposits into an existing account. Interest on the Easy Access Savings Account, which replaces the Ordinary Account, is all taxable.

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 (which are sometimes called single-premium bonds or investment bonds).

The insurer pays tax on the income and capital gains from investment in the fund into which your investment goes. All taxpayers, as well as non-taxpayers, therefore indirectly pay some tax. As a result, life insurance investment policies are not tax-free investments, whatever level of tax you pay. However, whether you pay any extra income tax on the proceeds of your insurance investment depends on whether the policy is a qualifying policy and on what tax band you fall into.

Qualifying policies

Most regular-premium policies, such as some endowments, are almost always what are known as qualifying policies. This means you pay no tax on the proceeds (unless you cash the policy in early – see 'Non-qualifying policies', below). You cannot claim the tax the provider has already paid (equivalent to the 20 per cent savings rate).

Non-qualifying policies

A qualifying policy becomes a non-qualifying policy if you cash it in or stop paying premiums in the first ten years (or, for shorter-term policies, before it is three quarters of the way through its term). Lump-sum policies and regular-premium policies of less than 10 years are also non-qualifying policies.

Because providers pay tax on the underlying investments, this covers your liability to savings-rate tax on non-qualifying investments. However, higher-rate taxpayers have to pay 20 per cent more income tax (the difference between savings- and higher-rate tax) on any gains that they make when they cash the policy in or the policy matures, or if more than 5 per cent of the capital is withdrawn in a year. This 5 per cent is a cumulative figure, so amounts that you do not use in any tax year can be used to increase the amount you can withdraw tax-free in subsequent years (up to a maximum of 100 per cent). However, any amounts withdrawn will be taken into account in calculating the gain when the policy comes to an end. Any gain on a non-qualifying life insurance policy also increases your income and may reduce age allowance and tax credits.

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

Friendly society plans

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 no 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 paid monthly. Because their investments are long term, some societies market their plans to people investing for children up to age 18 or 21. Friendly societies also sell standard insurance policies that are not tax-free. ■

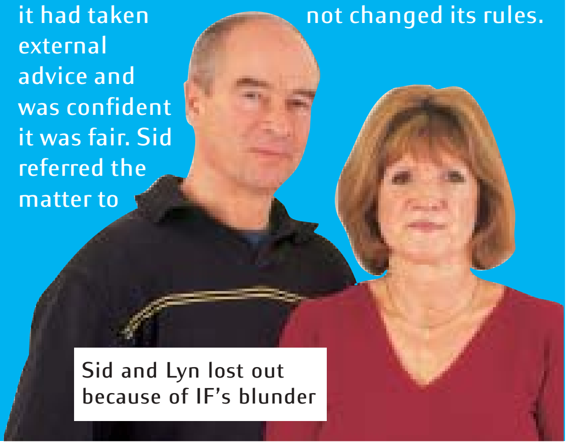
ISA ALLOWANCE LOST

Which? readers Sid and Lyn Quattrucci got their Isa applications into IF well in advance of the 2003-2004 deadline but the bank didn't process them before the cut-off date of 5 April. As a result, £6,000 (their tax-free allowance for the year) wasn't invested.

IF conceded there had been 'a neglect of duty' by some staff and offered Sid a deal which meant just £108 compensation. It volunteered to put the £6,000 into a top-paying savings account and to make up the difference in interest rates between this account and the Isa, taking into account the fact that interest on the savings account isn't tax-free. But this would last for only three years.

Sid didn't think the offer was fair and reasonable. Neither did we, so we asked IF to reconsider. It said it had taken external advice and was confident it was fair. Sid referred the matter to the Financial Ombudsman Service but it won't increase the compensation.

We've asked the Revenue to reconsider accepting late Isa applications where a customer has lost out because of an error on the part of the provider. So far it's not changed its rules.



Sid and Lyn lost out because of IF's blunder

MORE HELP

Revenue leaflets

- IR68 Accrued income scheme – taxing securities on transfer
- IR111 Bank and building society interest – are you paying tax when you don't need to?
- IR 320 Gains on UK life insurance policies
- IR 321 Gains on foreign life insurance policies
- IR2008 Isas, Peps and Tessas

Websites

- www.nsandi.com for NS&I products
- www.fsa.gov.uk/tables to compare products