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# Personal Taxation

## Learning Outcome 2.2

By the end of this learning outcome you will be able to demonstrate an ability to analyse the taxation of **indirect investments** as relevant to the needs and circumstances of individuals and trusts including pension arrangements, Individual Savings Accounts and Junior ISAs, onshore and offshore collectives and investment companies, and onshore and offshore life assurance policies.

### **2.2.1 Collectives**

The taxation of income received from a collective depends on the type of investment held within the fund.

Where the investment pays a dividend distribution, the taxation is the same as for shares, paid gross.

Interest distributions are taxed as savings income and will be paid gross. To qualify to pay an interest distribution on the whole of the fund there has to be more than 60% of the underlying investment placed in cash deposits and fixed interest securities.

Gains and losses on disposals of collectives are subject to CGT in the hands of the individual investor.

September 2009 saw a change to legislation that allows the introduction of Tax Elected Funds.

This allows the income paid from a fund to be specifically paid in proportion to the underlying investment, therefore paying both an interest distribution and a dividend distribution with the taxation to follow accordingly.

**Alison is a higher rate taxpayer.**

**She has made a gain of £14,000 on the disposal of her OEIC holding.**

**She has no previous gains or losses to take into account.**

**How much further CGT will she have to pay on her gain?**

Alison owes 20% of the gain in excess of the annual exempt amount.

$$£14,000 - £11,300 = £2,700 @ 20\% = \underline{£540}$$

<b>Collectives Summary</b>	<b>Income Tax (Dividend Income)</b>	<b>Income Tax (Interest Income)</b>	<b>CGT</b>
- Dividend Income - Interest Income	Within DA 0% Thereafter; NTP 0% STP 0% BRT 7.5% HRT 32.5% ART 38.1%	Within PSA –nil NTP – nil STP- nil BRT – 20% HRT 40% ART 45%	10% or 20% after annual exemption

### **2.2.2 Individual Savings Accounts (ISAs)**

The taxation of an ISA is as follows:

No income tax payable on interest or dividend distributions. And the payments do not count towards the personal savings allowance (PSA) or the dividends allowance (DA).

No capital gains tax.

UK residents that become non residents can maintain their ISA investments and still benefit from tax efficient growth, but they will not be able to add to their ISA, unless they become a UK resident again.

The ISA wrapper and tax advantages cease upon the date of death and the invested monies form part of the deceased's estate, just like any other investment would.

### **2.2.3 Junior Individual Savings Accounts (ISAs)**

The Junior ISA offers parents a tax-free way to save for their child's future. It replaced the Child Trust Fund for children living in the UK who are no longer eligible for it because they were born after 1<sup>st</sup> January 2011.

People will be able to put money into a cash account or 'stocks and shares' account. Each child will be able to have one cash and one 'stocks and shares' Junior ISA at any one time.

For the 2017/18 tax year, there is an annual JISA allowance, currently £4128. These accounts will become ISAs when the child is 18. This JISA allowance can be split between the cash or stocks and shares accounts in any proportion.

Any money the accounts make will be tax free.

Savers aged 16 or 17 are able to subscribe up to the full ISA allowance into a cash ISA (currently £20,000), but cannot open a stocks and shares account.

### **2.2.4 Child Trust Funds (CTFs)**

Child Trust Funds were introduced for children born after 31 August 2002 and before 3 January 2011.

Linked to the receipt of Child Benefit, an initial voucher of £250 was sent automatically. Children of low earning families, in receipt of full Child Tax Credit, received an additional £250.

At the age of seven, all children received an additional voucher worth £250, with children of low earning families receiving an extra £250.

Children born after 1 August 2010 only qualified for a CTF contribution of £50 (£100 for low income families) and from 1<sup>st</sup> January 2011, there were no new CTF contributions. From 1 August 2010, there were no seven year government CTF contributions either.

No new CTFs can be taken out, but the limit per year for additional savings is in line with Junior ISAs (see 2.2.3).

The taxation for CTFs is as follows:

- No income tax payable on interest or dividends
- No capital gains tax.

Where income created is in excess of £100 this will not be taxed against the parent.

### **2.2.5 Friendly Society Policies**

Friendly Societies are allowed to issue 'qualifying policies' with limited premiums.

Qualifying means that the policy is exempt from both income and capital gains at maturity.

The underlying fund is also exempt from these taxes and so will grow faster than a fund held under an ordinary life policy.

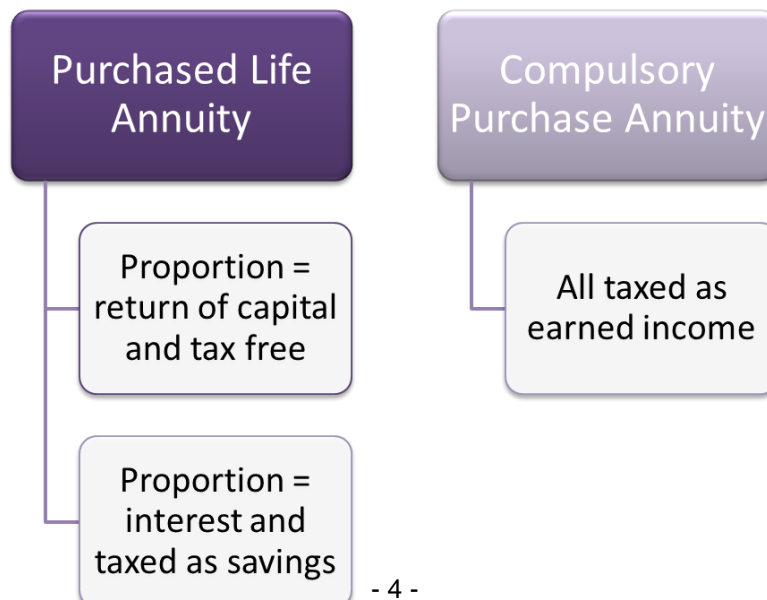
#### **Conditions applying to Friendly Society Policies**

- Premiums of a policy must not exceed £270 per annum (for annual premiums) or £300 per annum for more frequent premiums (£25 per month or £5.70 per week)
- These contribution limits are applied to the total plans held by an investor
- Policies are available from age 18 to a maximum age of 70 in the individual's own name
- Policies can be taken out for children from birth

### **2.2.6 Annuities**

An annuity is an income given for life in return for a lump sum.

The taxation of an annuity depends on whether the funds used to purchase the annuity were from the individual's own funds, in which case it will be taxed as a 'Purchased Life Annuity', or from the proceeds of a UK pension scheme in which case it will be taxed as 'Compulsory Purchase Annuity':



The proportion of a purchased life annuity deemed to be a return of capital and the proportion deemed to be interest is determined by HMRC and will depend on the life expectancy of the individual buying the annuity.

As a rough guideline, the longer the life expectancy, the smaller the return of capital and the larger the interest element. The opposite holds true for a shorter life expectancy.

Have a go at the examples below:

**A purchased life annuity provides an income of £10,000 per annum. £8,000 is deemed to be a return of capital, £2,000 is deemed interest. What is the tax position of non taxpayers, those who have the full starting rate for savings band available to them, basic rate taxpayers, higher rate taxpayers and additional rate taxpayers?**

For all, £8,000 (the capital content) is tax free.

Note: Unless a non-taxpayer who elects to receive gross, tax at 20% is deducted at source from the interest content.

Non taxpayers	- £2,000 tax free, either gets paid gross or reclaim
Starting rate	- liable for tax at 0%, so can reclaim the tax deducted at source
Basic rate	- First £1,000 covered by the PSA, £1,000 liable for tax at 20%, so half of the tax deducted at source can be reclaimed
Higher rate	- First £500 covered by the PSA, balance liable to tax at 40% less a credit for the tax deducted at source
Additional rate	- no PSA available, so need to pay an additional 25% of the gross interest

**A compulsory purchase annuity provides an income of £10,000 per annum.**

**What is the tax position of non taxpayers, those who have the full starting rate for savings band available to them, basic rate taxpayers, higher rate taxpayers and additional rate taxpayers?**

Non taxpayers	- reclaim all the tax deducted at source
Starting rate	- no reclaim as deemed to be earned income
Basic rate	- have their liability met at source
Higher rate	- HMRC will collect from provider additional 20%
Additional rate	- HMRC will collect from provider additional 25%

NOTE: As the payments are earned income, not savings income, the PSA does not apply.

There are a number of circumstances where the tax treatment of an annuity is not immediately obvious. These are listed below:

### **Tax Treatment of Annuities**

<b>Immediate Needs Annuity</b>	Anyone purchasing an Immediate Needs Annuity can benefit from an exemption to any income tax if the annuity issued is based on a person of impaired life and is being used for long term care with the payments being made directly to the care home.
<b>Settlements</b>	Sometimes annuities are paid in settlement of a claim for damages in a personal accident / injury action. When this occurs they are commonly referred to as structured settlements and the annuity can then be paid directly without deduction of tax to the recipient and without becoming taxable in the hands of the individual.
<b>Wills and Trusts</b>	Where an annuity is purchased as a result of a direction within a trust or a will, it has not been purchased by the individual from their free monies and therefore will not be deemed to meet the rules for part return of capital for tax purposes. In this event, the individual will be deemed to be liable to savings tax on the total payment they receive.

### **2.2.8 Taxation of UK Life policies**

Taxation of a UK life policy is determined by whether it is 'qualifying' or not.

To be a qualifying policy the following criteria must be met:

#### **Criteria for being a 'Qualifying Policy'**

- Must secure a capital sum on maturity, death or earlier disability, and any term must be at least 10 years.
- Premiums must be payable annually or more frequently
- For term assurance policies the sum assured must not be less than 75% of the premiums payable during the term of the policy
- For whole of life policies the sum assured must not be less than 75% of the total premiums payable should death occur at age 75
- Premiums payable in any one year must not exceed twice the premiums payable in any other year
- Premiums payable in any one year must not be more than 1/8th of total premium payable over the policy term (or the first 10 years for a whole of life with premiums payable throughout life).

An annual limit on contributions to qualifying policies of £3,600 came into effect from 6 April 2013. Any policies held by an individual which breach this limit will be non-qualifying even if they meet all the other qualifying rules.

Transitional rules mean that all policies taken out now will effectively be in the same position, as a large reduction in premiums would result in the loss of qualifying status.

If the rules for qualifying policies are broken the policy can become non-qualifying and there could be a tax liability for the policyholder when any money is withdrawn.

However, a policy will retain its qualifying status if, on surrender or assignment for money or monies worth:

- Premiums have been paid for at least the lesser of  $\frac{3}{4}$  of the term or ten years
- If a whole of life policy, premiums have been paid for at least 10 years

Policies which do not meet the criteria outlined above are called non-qualifying policies.

All single premium bonds are non-qualifying as they do not meet the requirement of regular premiums.

With non-qualifying policies there is the possibility of an income tax liability for the policyholder when any money is withdrawn.

The differences in taxation of qualifying and non qualifying policies are shown below:

<b>Qualifying</b>	<b>Non Qualifying</b>
Fund taxed on income and gains at an assumed rate of 20%	Fund taxed on income and gains at an assumed rate of 20%
No further tax payable on encashment	Additional 20% or 25% payable on the chargeable gain in excess of basic rate tax band

For non-qualifying policies, tax is only payable on the policy proceeds if all three of the following arise:

- A chargeable event occurs
- A gain arises from the chargeable event
- The gain, subject to top-slicing, added to the taxpayer's total income for the year, takes it into the higher / additional rate tax bracket

Chargeable events include:

### Chargeable Events

- Death of the life assured resulting in a payment
- Assignment of the policy for money or monies worth.
- Maturity of the policy
- Part Surrender – excess occurring on partial surrenders over 5% allowance
- Surrender of the policy

There is no liability to basic rate income tax or capital gains tax on any policy proceeds. However, if, when added to income in the tax year in which the chargeable event is treated as occurring, any of the total chargeable gain comes within the higher rate or additional rate tax band, then it may be chargeable to income tax at the excess rate, i.e. 20% or 25%.

It is the individual's responsibility to inform HMRC of any gains they make in order for tax to be accounted and paid. The life company will issue a Chargeable Event Certificate to the client including the amount of the gain to complete a self assessment form. (If the total gain exceeds more than half of the current basic rate band ( $£38,500 / 2 = £16,750$ ) or was in respect of an assignment for money or money's worth, the life company will also forward a copy to HMRC.) Some life companies report all their chargeable gains via electronic reporting.

The table overleaf shows how the tax is calculated.



<b>Step 1</b>	<p><b>Calculate the total investment gain from the policy</b></p> <ul style="list-style-type: none"> <li>• In basic terms the gain is the profit made (but the calculation differs for each type of event)</li> <li>• The calculation takes into account previous withdrawals and taxable gains already made</li> <li>• Joint policies gain split 50/50 unless specific ownership is shown otherwise.</li> <li>• For Age and income limit for personal allowance purposes the total gain is added to income.</li> </ul>
<b>Step 2</b>	<p><b>Calculate the Annualised Gain</b></p> <p>Gain divided by number of complete years' investment held (or last chargeable event for part-surrenders).</p>
<b>Step 3</b>	<p><b>Establish Customers Income Tax position</b></p> <ul style="list-style-type: none"> <li>• How much, if any, unused allowance is there at Basic Rate?</li> <li>• Remember – Basic rate tax of 20% has been accounted for within the fund</li> <li>• If already paying Higher Rate Income Tax - then take total gain from Step 2 and multiply by a further 20%.</li> <li>• If already paying Additional Rate Income Tax - then the total gain from Step 2 and multiply by a further 25%.</li> <li>• If the client is a Non taxpayer – there is no reclaim permitted.</li> </ul> <p>For all other clients – move to Step 4</p>
<b>Step 4</b>	<p><b>Calculate any Slice of Tax for a Basic Rate Taxpayer</b></p> <ul style="list-style-type: none"> <li>• Remember - Tax has been taken at Basic Rate within the Investment</li> <li>• Add the Annualised gain to the individual's taxable income and calculate any amount which falls into the Higher Rate Tax Band (if none, then no tax payable by claiming top slicing relief)</li> <li>• Take this slice of income and multiply by difference between Basic and Higher Rate i.e. 20%</li> <li>• This results in the additional tax payable by the individual per year the investment has been held</li> <li>• Multiply by the total number of whole years held to identify the additional income tax payable</li> <li>• You can also do this calculation for those who straddle the Higher Rate and Additional Rate Bands – in this instance you'd take the slice of income which falls into the Additional rate and multiply by the difference between Higher and Additional Rate i.e. 5% (having already taxed the 'slice' at 20%).</li> </ul>

**NOTE:** For basic rate taxpayers, there is no benefit of the PSA as this falls within the 20% tax credit for tax already paid within the fund which is non-recoverable. Higher rate taxpayers will receive a tax benefit of £100 (being £500 x 40% less the 20% non-recoverable tax credit)

Depending whether or not withdrawals have been made, the chargeable gain will be as follows:

On the full encashment of the policy, where no withdrawals have been made, the chargeable gain is the overall profit made. For example:

- Encashment value / policy proceeds      £20,000
- Original investment / premium            £15,000
- Chargeable Gain                                £ 5,000

On full encashment where withdrawals have not exceeded 5% per annum, the chargeable gain will be:

Encashment value + previous withdrawals – original investment.

Have a go at this example:

**A higher rate taxpayer purchases an investment bond for £10,000, withdraws £500 per annum for five years and then surrenders the bond for £15,000.**

**How much is the chargeable gain?**

The chargeable gain would be:

$$£15,000 + £2,500 - £10,000 = £7,500$$

On full encashment where withdrawals are in excess of 5% per annum, the chargeable gain will be:

Encashment value + previous withdrawals – (original investment + previous chargeable gains)

Have a go at this example:

**A higher rate taxpayer purchases an investment bond for £10,000, withdraws £700 per annum for five years and then surrenders the bond for £15,000 just after the 5<sup>th</sup> anniversary.**

**How much is the chargeable gain?**

The chargeable gain would be:  $£15,000 + £3,500 - (£10,000 + £1,000) = £7,500$

£15,000 (Final encashment value)

£3,500 (£700 withdrawals x 5 years)

£10,000 (Initial investment)

£1,000 (5% of the initial investment can be withdrawn each year without any immediate tax liability. Any excess over the 5% is a chargeable gain and therefore liable to immediate tax. In this example, the 5% allowance is £500, with the £200/year excess resulting in the previous chargeable gains being £1,000 (£200 x 5 years)).

Have a go at this example which covers off what happens when a gain takes a basic rate taxpayer into the higher rate bracket.

**Carl buys an investment bond in 2013 for £20,000 and cashes it in just over 4 years later for £40,000. (NOTE: His PSA has already been used.)**

**His total gross income for the year of encashment is £43,000.**

Gross income	£43,000
Less personal allowance	<u>£11,500</u>
Taxable income	£31,500

Gain =  $£40,000 - £20,000 = £20,000$

Top Slice =  $\frac{£20,000}{4} = £5,000$

Add top slice to taxable income  $£31,500 + £4,000 = £36,500$

Apply appropriate rate of tax to the gain

$£36,500 - £33,500 = £3,000$  of the slice falls within the higher rate tax band.

Therefore tax at 20% will be due on the £3,000 multiplied by the 4 complete years the policy has been held.

Tax due =  $£3,000 \times 20\% \times 4 = £2,400$

Let's look at another example:

Jen buys an investment bond in 2012 for £20,000 and cashes it in just over 5 years later for £30,000. Her total gross income for the year of encashment is £18,000

Gross income	£18,000
Less personal allowance	<u>£11,500</u>
Taxable income	£6,500

Gain = £30,000 – £20,000 = £10,000

Taxable income plus the gain (£6,500 + £10,000 = £16,500) does not exceed the basic rate tax band so top slicing is not relevant. There is no additional income tax to pay.

A withdrawal from a policy is normally regarded as a partial surrender.

For additional and higher rate taxpayers, or basic rate taxpayers near the higher rate threshold, the timing of withdrawals and final encashment is important.

Those who are near to retirement may be able to defer liability to additional and higher rate tax if on retirement their income reduces below these thresholds. However, they need to consider the effect the gain may have on any means-tested benefits or allowances.

Withdrawals up to the 5% limit are technically a return of the investor's original capital.

These 5% allowances accumulate if the policyholder does not use them in a given policy year. Thus, a policyholder who did not make any withdrawals for three years could, in the fourth year, withdraw 20% (i.e. the accumulated 15% allowance from the previous 3 years plus the 4<sup>th</sup> year's 5% allowance).

However, the cumulative total cannot exceed 100% of the amount invested. So a 5% withdrawal could be made for 20 years, or alternatively nothing for 25 years and then 100% in the 26<sup>th</sup> year.

Most single premium investment bonds are issued as 'segments', i.e. a number of small policies usually identical to each other, to enable withdrawals to be made more easily. Instead of issuing 1 policy for £100,000, 100 policies (segments) could be issued for £1,000 each.

Each policy (or segment) is treated separately for tax purposes. This means that where only part of the investment is to be withdrawn, there can be tax advantages of fully encashing a number of segments rather than a part of all segments. This is especially the case in the early years of the investment or where the 5% tax deferred allowances have already been used.

**Carl invested £10,000 in a bond 4 years ago. The bond is now valued at £15,000. Carl is a higher rate taxpayer. He wishes to withdraw £6,000.**

**For a part-surrender across all segments:**

Withdrawal of £6,000 less allowable 5% allowances of £2,000 gives a chargeable gain of £4,000. Higher rate tax on total gain is  $£4,000 \times 20\% = £800$ .

**By surrendering individual policies (segments):**

Assume the bond was segmented into 10 policies. Each segment is now worth £1,500. To withdraw £6,000 need to encash 4 policies. Gain on each encashment is £500. Total gain of 4 segments = £2,000.  $£2,000 \times 20\% = £400$ .

In this example, withdrawing the money by fully encashing individual policies has saved Carl £400 in tax.

An indirect tax charge may be incurred by policyholders who are born before 6/4/1938 and receiving the higher married couple's allowance.

Where a chargeable gain arises, the total excess of the proceeds over premiums paid is added to the policyholder's total income.

If this takes him or her over the limit for age allowance eligibility (£28,000 2017/18) the allowance will be reduced or even lost for that year.

Top slicing relief cannot be applied to avoid any impact on the married couples allowance age allowance. This also applies where total income exceeds £100,000, where the basic personal allowance is also reduced/lost.

### **2.2.8.1 Second Hand Policies**

As an alternative to surrendering an endowment policy mid-term, the policyholder may have the option to sell the policy to a third party.

The person buying the policy continues to pay the premiums and receives the maturity value at the end of the term by way of the return on his investment.

The sale of the policy may produce more cash for the policyholder than surrendering.

The sale is an "assignment for consideration" and therefore may have the following tax consequences for the original and new policyholders. NB: from 6 April 2013, such assignments will render the policy non-qualifying.

Taxation of second hand policies is as follows:

For the Seller of a Qualifying Policy:

- There is no tax liability

For the Seller of a Non-Qualifying policy:

- They pay tax under the chargeable events rules i.e. no tax is payable unless the profit/gain push them into the higher rate band
- There may be other impacts e.g. loss of Married Couples Allowance

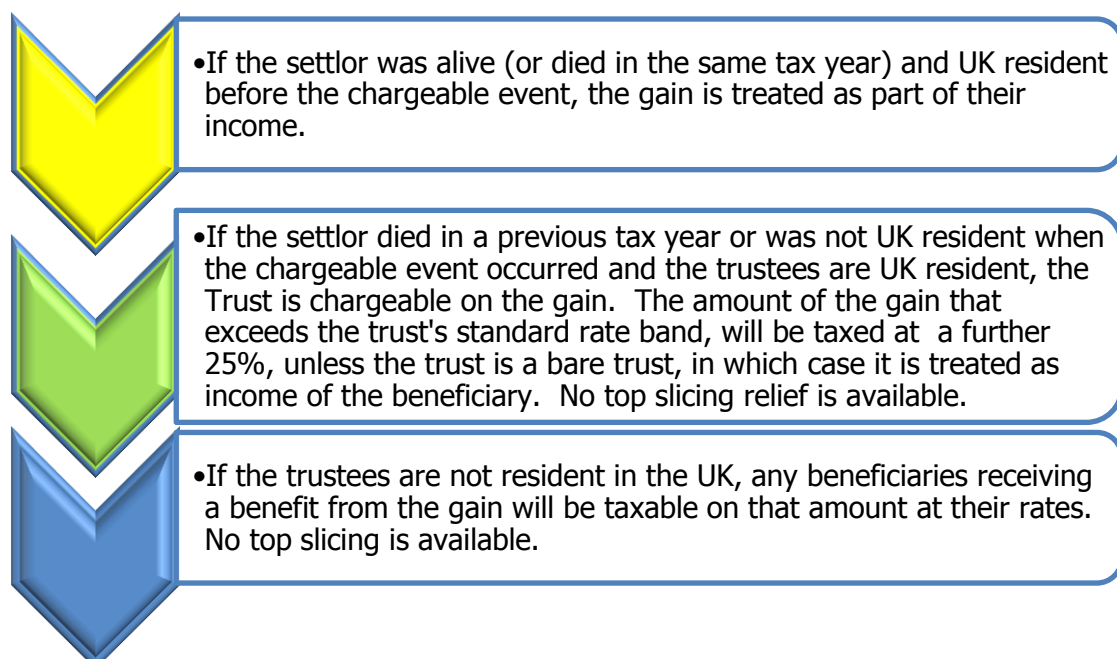
For the Buyer (remember, the policy will always now be non-qualifying):

- They pay tax under the chargeable events rules i.e. no tax is payable unless the gain push them into the higher rate band
- There may be other impacts e.g. loss of Age Allowance
- Capital gains tax may also be payable

### **2.2.8.2 Life Policies under Trust**

The income tax treatment of a life policy written under trust differs from the tax treatment of life policies outside of a trust.

If a chargeable event gives rise to a chargeable gain then income tax is due as follows:



### **2.2.8.3 Offshore Life Policies**

The funds underlying an offshore policy are not subject to UK corporation tax.

The gross-roll up of funds provides a boost to performance, since for any assumed return, an investment will build up faster than in an equivalent life fund which is subject to tax.

However, where funds invest in assets in countries where the income is taxed at source, this withholding tax may not always be recoverable.

Offshore policies may benefit from double taxation agreements between governments of different countries. The purpose of the agreement is to prevent tax being paid in both countries in respect of the same income.

'Time apportionment relief' may be available in respect of a chargeable gain under an offshore policy (and onshore policies from 6 April 2013) if the policyholder has been resident for tax purposes outside the UK for part of the period since the policy started.

Take a look at the example below:

**Jan is retired and is a basic rate taxpayer and has spent 5 out of the last 10 years living outside the UK.**

**Assume she took out an investment bond 10 years ago for £20,000 and it is now worth £30,000.**

**How much do you think her tax bill will be if she encashes the bond?**

Current value of bond	£30,000
Original value of bond	<u>(£20,000)</u>
Gain	<u>£10,000</u>

Jan spent 5 out of the last 10 years out of the UK and therefore the gain is reduced by 50%.

Tax due                                      £5,000 x 20% = £1,000

The actual calculation is done using "days" rather than "years" but the principle of proportioning is the same.

There are some key differences to remember between the taxation of onshore and offshore bonds:

### Taxation of offshore bonds:

- Offshore Bonds pay a gross income rolled up in the fund
- Gains from Offshore bonds are taxed as savings income at the full marginal rate
- Tax could be due even if funds not remitted to UK.

<b>Step 1</b>	<p><b>Calculate the total gain from the Investment</b>            Sale Proceeds less Purchase Price = Gain</p>
<b>Step 2</b>	<p><b>Calculate the proportion of the gain that relates to number of years UK resident</b></p> <p style="text-align: center;"> <math display="block">\frac{\text{Total Gain} \times \text{Number of days UK Resident}}{\text{Total number of days of ownership}} = \text{proportion of total gain to tax}</math> </p>
<b>Step 3</b>	<p><b>Calculate the Proportionate Annualised Gain (top sliced gain)</b>            Proportionate Gain divided by number of complete days investment held whilst UK Resident</p>
<b>Step 4</b>	<p><b>Establish Customers Income Tax position</b></p> <ul style="list-style-type: none"> <li>• If the client is already paying Additional Rate Income Tax – then simply take the total gain from Step 2 and multiply by 45%</li> <li>• If the client is already paying Higher Rate Income Tax - then simply take the total gain from Step 2 and multiply by 40%</li> <li>• If the client is a Non taxpayer – then you need to establish if the gain would take them to the basic rate band</li> <li>• If the client is a Basic taxpayer – then you need to establish if the gain would take them to the higher rate band</li> <li>• If the client is a Higher taxpayer – then you need to establish if the gain would take them into the additional rate band</li> </ul>
<b>Step 5</b>	<p><b>Calculate any Slice of Tax</b></p> <p>Add the annualised gain to the individual's taxable income to determine how much of the gain falls into the savings rate band. The remaining gain is taxed at 20%. This gives you the basic rate income tax liability.</p> <p>Then, add the annualised gain to the client's other income.            If the total takes him into the higher rate income tax band, calculate the higher rate liability ie multiply that part of the annualised gain which falls into the higher rate band by 20%.            Then multiply this figure by the total number of years held to give the amount of higher rate income tax payable.</p>



NB: For partial surrenders , “offshore” bonds taken out or varied after 6 April 2013 may only be top-sliced back to inception or the most recent chargeable event.

NOTE: As there is no tax deducted from the fund, the taxpayer will receive the full benefit of their PSA.

Whenever a chargeable event occurs and a gain arises, the life office will issue to the investor a certificate containing the information they will need to complete their tax return. Payment of any additional tax is the responsibility of the individual and will be calculated through the self assessment system.

A copy of the certificate will also be forwarded by the life office to HMRC if the event was due to an assignment for money or money’s worth, or the amount of the gain exceeds half of the basic rate tax band, i.e. £16,500 (2017/187) or more. Some life offices report all chargeable gains to HMRC annually by electronic reporting.

### **2.2.9 Offshore Reporting and Non Reporting Funds**

Many providers offer offshore investment funds to their clients where the underlying investment within the fund is in equities, fixed interest stocks, commodities and currencies.

These funds are generally set up in countries with little local taxation e.g. Channel Islands, Isle of Man, and Luxembourg. They may be suitable for many investors and are considered suitable for those not resident in the UK.

For tax purposes offshore funds are split into two types and follow slightly different taxation as shown in the table on the next page.

	<b>Features, Tax treatment ( UK Residents)</b>	
<b>Reporting Funds</b>	<p>Must report all income.</p> <p>Must apply annually for Reporting Fund status</p> <p>Dividends are paid to investors gross – tax is therefore 7.5%,32.5% and 38.1%</p> <p>Capital Gains made by the individual investor are subject to CGT and annual exemption applies along with other gains made</p> <p>Distributor status is given annually</p>	
<b>Non Reporting Fund</b>	<p>Income is accumulated</p> <p>Gain on disposal are taxed as Income tax and therefore no annual CGT exemption can be utilised</p> <p>Gain = sale proceeds less purchase price Taxed as income tax and therefore 20%, 40% and 45%</p> <p>No CGT to pay so no offset permitted</p>	
	<b>Income Tax</b>	<b>CGT</b>
<b>Reporting</b>	<p>Dividend distributions, in excess of the dividend allowance @ 7.5%, 32.5% or 38.1%.</p> <p>Income distributions @ 0% (up to the personal savings allowance and the savings rate band), 20%, 40% or 45%.</p>	10% on gains (20% for higher and additional rate taxpayers). Annual exemption applies.
<b>Non Reporting</b>	Total gain including accumulation charged to income tax @ 20% , 40% or 45%	N/A

For UK residents, Reporting funds are likely to be more advantageous as they generally have lower tax charges applied to dividends and CGT is payable at 10% for low and middle-income taxpayers, and 20% for higher and additional taxpayers.

### **2.2.10 Enterprise Investment Scheme**

The purpose of the Enterprise Investment Scheme (EIS) is to help small unquoted trading companies to raise capital.

An investor who has realised a gain from an investment can get CGT deferral relief if he invests the gain within the timeframe of 12 months before the gain arose and 36 months afterwards.

Under an EIS the investor may also obtain income tax relief at 30% on the amount invested up to a total of £1,000,000 (2017/18) for shares issued in any one tax year.

This relief is given by a reduction in the amount of income tax an EIS investor pays.

**Charles has a capital gain of £40,000 which arose 6 months ago.**

**He wishes to invest this in an EIS.**

**His income tax liability for the current year is £20,000.**

**What is the impact of investing in the EIS on his CGT and income tax bills?**

If Charles invests the £40,000 into an EIS there will be no CGT to pay on his original gain at present.

It will be deferred until he cashes in his EIS when the gain will become liable.

If he dies whilst still holding the EIS then there will be no CGT to pay at all.

He is entitled to 30% income tax relief of the £40,000.

£40,000 @ 30% = £12,000.

As his tax liability is £20,000 he can take the £12,000 off this giving him a final tax bill of £8,000.

You should note that if a person does not have a tax liability, the tax relief will not be given.

The shares must be held for at least three years for the income tax relief to be claimed in full. If the shares are sold before that time then the income tax relief will be withdrawn.

A capital gain arising on disposal of any of the shares under an EIS will be exempt from capital gains tax where the shares have been held for at least 3 years, provided the investor received income tax relief. Any losses made, less any income tax relief given, are allowable against either CGT or Income Tax.

When considering investing in an EIS, the tax benefits available should be considered against the potentially high risks attached to this type of investment.

In addition, there are many conditions which need to be satisfied by the EIS:

### **EIS Conditions**

- The company must have gross assets of not more than £15m before an investment, and no more than £16m after
- The company must carry on a qualifying trade for at least three years
- The company must trade in the UK, but need not be incorporated or resident in the UK
- The company must be unlisted when the EIS shares are issued and there must be no arrangements at that time for it to become listed. An AIM share counts as unlisted
- The company must have fewer than 250 full-time employees (or their equivalents) at the time the shares are issued, or 500 for "knowledge intensive companies"
- The company must have raised no more than £5m under the EIS, as the holding company of a venture capital trust or under the corporate venturing scheme in the twelve months ending on the date the investor subscribed for the shares
- Total investments a company may receive through EIS and VCT's cannot exceed £20 million for "knowledge intensive companies" and £12 million for other qualifying companies.

#### **2.2.10.1 Seed Enterprise Investment Schemes (SEIS)**

The 2012 budget introduced a new type of EIS that operates in the same way as the main EIS but is aimed at small early stage companies recognising the particular difficulties these companies may have in attracting investment.

Tax relief is given at a rate of 50% on investments up to £100,000 (tax year 2017/18) with the same requirement to hold the shares for three years and the other reliefs being the same as those for EIS.

Although originally intended to be on a temporary basis, the tax benefits of SEIS were made permanent in the 2014 Budget.

#### **2.2.11 Venture Capital Trusts (VCTs)**

VCTs are companies listed on the London Stock Exchange.

They are designed to encourage individuals to invest in certain types of small higher-risk trading companies not listed on the official list of any stock exchange and are run by fund managers.

Investors in VCTs are able to spread the investment risk over a number of trading companies and are entitled to various income and capital gains tax reliefs.

Like EIS investments, income tax relief is available at the rate of 30% in the tax year when the investment is made into VCT shares.

The maximum amount which can attract this relief is £200,000 (2017/18) and the shares must be held for at least five years. VCT investors also receive an income tax exemption on dividends from ordinary shares.

VCTs are exempt on capital gains arising on the disposal of their investments (no minimum investment time limits apply). Losses are not allowable and CGT deferral is not available on the initial investment.

Investors have no further liability to tax on the dividends they receive.

These reliefs can be obtained by those aged 18 or over, on shares in VCTs up to a maximum of £200,000 per tax year.

### VCT Conditions

- The VCT must not be a close company
- The VCT must be listed on the Stock Exchange
- Its income must be derived wholly or mainly from shares or securities
- At least 70% of its investments by value must be in qualifying unlisted trading companies (including companies traded on the AIM). This must not include guaranteed loans and securities.
- No more than 15% can be in any one company or group.
- At least 10% of the investment in any company must be held in ordinary, non preferential shares
- At least 30% of its investments by value in qualifying holdings must be in new ordinary shares
- The remaining investments may be in other shares or loans with a minimum term of five years
- The companies the VCT invests in must satisfy a number of other conditions which are similar to the ones applying to EIS companies

The image below highlights the main differences between EISs and VCTs:

EIS	VCT
<ul style="list-style-type: none"><li>• £1,000,000</li><li>• 30% income tax relief after 3 years</li><li>• Dividends taxable</li><li>• CGT free on disposal after 3 years</li><li>• CGT deferral relief on initial investment</li></ul>	<ul style="list-style-type: none"><li>• £200,000</li><li>• 30% income tax relief after 5 years</li><li>• Dividends not taxable</li><li>• CGT free on disposal from outset</li><li>• No CGT deferral relief on initial investment</li></ul>

## **2.2.12 Real Estate Investment Trusts (REITs)**

Real Estate Investment Trusts (REITs) are investment trusts that enable investors to put money into the property market by buying shares in the investment trust.

A REIT must be UK resident and are closed-ended companies listed on the stock exchange

They have a ring fenced property lettings element which is exempt from corporation tax providing at least 75% of the REIT's gross profits originate from property letting. And a non ring fenced element consisting of other associated property business which may be subject to corporation tax.

At least 90% of the profits from the ring fenced element must be distributed to shareholders within 12 months of the end of the accounting period. For investors, a payment from the ring fenced element is classed as property income.

A payment from the non ring fenced element is classed as a dividend and taxed accordingly.

Gains on REIT shares are subject to CGT.

A summary of investor taxation of the two elements of REITs is shown below:

<b>Ring fenced</b>	<b>Non Ring Fenced</b>
<ul style="list-style-type: none"><li>• Property lettings element</li><li>• 90% profits must be distributed to shareholders within 12 months</li><li>• Payments to shareholders classed as property income</li></ul>	<ul style="list-style-type: none"><li>• Associated property business</li><li>• Payments to shareholders classed as dividends</li></ul>

Personal Taxation Learning Outcome 2.2 (TAX2.2) – End of Module Test

**Multiple Choice Questions**

Question	Answer	
<b>2.2.1 -</b> Bob invested £20,000 into a single premium onshore investment bond 7 years ago. No withdrawals have been made and it has now been fully surrendered for £27,000. Bob has income in excess of the basic rate band and has already used his personal savings allowance. How much tax will he have to pay on surrender?	A.	£0
	B.	£200
	C.	£1,400
	D.	£2,800

<b>2.2.2 -</b> Joan invests £30,000 into a single premium onshore investment bond on 25th November 2007. She fully encashes the bond on 1st September 2017 for £35,000 and made no withdrawals in between. Her income less allowances is £155,000. How much tax will she pay on surrender?	A.	£200
	B.	£1,000
	C.	£1,250
	D.	£2,500

<b>2.2.3 -</b> Derek has annual earnings of £60,000. He is surrendering an offshore bond with a gain of £24,000 and onshore bond with a gain of £10,000 and has already used his personal savings allowance. How much is the total tax liability on these?	A.	£6,800
	B.	£9,600
	C.	£11,600
	D.	£13,600

<b>2.2.4 -</b> How is a purchased life annuity taxed?	A.	All taxed as savings income
	B.	All taxed as earned income
	C.	Part taxed as savings income, part tax free
	D.	Part taxed as earnings income, part tax free

<b>2.2.5 -</b> Peter, a higher rate taxpayer, invests £50,000 into Enterprise Investment Scheme (EIS) shares in tax year 2017/2018. How much tax relief will this give him?	A.	£10,000
	B.	£15,000
	C.	£20,000
	D.	£50,000

<b>2.2.6 -</b> Audrey invests £100,000 into VCT in the 2017/2018, how much could she reduce her tax bill by?	A.	Nil
	B.	£20,000
	C.	£30,000
	D.	£40,000

<b>2.2.7 -</b> Karen has a large portfolio of shares which she is considering selling. When must any gain be reinvested if she is to benefit from EIS CGT deferral relief?	A.	No later than 1 year after the disposal
	B.	No later than 3 years after the disposal
	C.	No later than 5 years after the disposal
	D.	No later than 7 years after the disposal

<b>2.2.8 -</b> Which of the following statements regarding REITs is FALSE?	A.	Investors pay no CGT in respect of capital gains from the exempt element
	B.	The REIT must be UK resident to benefit from tax concessions
	C.	Sales of developed property may be subject to 30% tax within the fund
	D.	Where conditions are met they are free of corporation tax



<b>2.2.9</b> - Which of the following is a feature of an EIS?	A.	Shares are free from CGT on disposal at any time
	B.	Providers must agree to buy back shares after 3 years
	C.	Maximum investment is £200,000
	D.	Tax relief is given as a reduction in tax due

- **End of Questions** -

## Answers

Question	Answer	
<p><b>2.2.1 -</b> Bob invested £20,000 into a single premium onshore investment bond 7 years ago. No withdrawals have been made and it has now been fully surrendered for £27,000. Bob has income in excess of the basic rate band and has already used his personal savings allowance. How much tax will he have to pay on surrender?</p>	C	£1,400
<p><b>2.2.2 -</b> Joan invests £30,000 into a single premium onshore investment bond on 25th November 2007. She fully encashes the bond on 1st September 2017 for £35,000 and made no withdrawals in between. Her income less allowances is £155,000. How much tax will she pay on surrender?</p>	C	£1,250
<p><b>2.2.3 -</b> Derek has annual earnings of £60,000. He is surrendering an offshore bond with a gain of £24,000 and onshore bond with a gain of £10,000 and has already used his personal savings allowance. How much is the total tax liability on these?</p>	C	£11,600
<p><b>2.2.4 -</b> How is a purchased life annuity taxed?</p>	C	Part taxed as savings income, part tax free

<p><b>2.2.5 -</b> Peter, a higher rate taxpayer, invests £50,000 into Enterprise Investment Scheme (EIS) shares in tax year 2017/2018. How much tax relief will this give him?</p>	B	£15,000
<p><b>2.2.6 -</b> Audrey invests £100,000 into VCT in the 2017/2018, how much could she reduce her tax bill by?</p>	C	£30,000
<p><b>2.2.7 -</b> Karen has a large portfolio of shares which she is considering selling. When must any gain be reinvested if she is to benefit from EIS CGT deferral relief?</p>	B	No later than 3 years after the disposal
<p><b>2.2.8 -</b> Which of the following statements regarding REITs is FALSE?</p>	A	Investors pay no CGT in respect of capital gains from the exempt element
<p><b>2.2.9 -</b> Which of the following is a feature of an EIS?</p>	D	Tax relief is given as a reduction in tax due